# NOTE

This Microfiche meets the quality requirements of the American National Standard for Microfiche of Documents (ANSI PH5.9-1975). However, because of imperfections in the document from which it was made, it contains images that are illegible or difficult to read. The source document for this microfiche is the best copy that could be obtained prior to filming.

CIS

# LONG-TERM STRATEGIES FOR PROGRAMS AND ISSUES WITHIN THE JURISDICTION OF THE COMMITTEE: NATIONAL SAVINGS RATE OF THE UNITED STATES AND ITS TRADING PARTNERS

## HEARINGS

BEFORE THE

COMMITTEE ON WAYS AND MEANS
HOUSE OF REPRESENTATIVES
ONE HUNDRED FIRST CONGRESS
FIRST SESSION

APRIL 19 AND 20, 1989

**Serial 101-21**

Printed for the use of the Committee on Ways and Means

U.S. GOVERNMENT PRINTING OFFICE
21-140 WASHINGTON : 1989

For sale by the Superintendent of Documents, Congressional Sales Office
U.S. Government Printing Office, Washington, DC 20402

H781-73

## COMMITTEE ON WAYS AND MEANS

DAN ROSTENKOWSKI, Illinois, *Chairman*

SAM M. GIBBONS, Florida
J.J. PICKLE, Texas
CHARLES B. RANGEL, New York
FORTNEY PETE STARK, California
ANDY JACOBS, Jr., Indiana
HAROLD FORD, Tennessee
ED JENKINS, Georgia
RICHARD A. GEPHARDT, Missouri
THOMAS J. DOWNEY, New York
FRANK J. GUARINI, New Jersey
MARTY RUSSO, Illinois
DON J. PEASE, Ohio
ROBERT T. MATSUI, California
BERYL ANTHONY, Jr., Arkansas
RONNIE G. FLIPPO, Alabama
BYRON L. DORGAN, North Dakota
BARBARA B. KENNELLY, Connecticut
BRIAN J. DONNELLY, Massachusetts
WILLIAM J. COYNE, Pennsylvania
MICHAEL A. ANDREWS, Texas
SANDER M. LEVIN, Michigan
JIM MOODY, Wisconsin

BILL ARCHER, Texas
GUY VANDER JAGT, Michigan
PHILIP M. CRANE, Illinois
BILL FRENZEL, Minnesota
DICK SCHULZE, Pennsylvania
BILL GRADISON, Ohio
WILLIAM M. THOMAS, California
RAYMOND J. McGRATH, New York
HANK BROWN, Colorado
ROD CHANDLER, Washington
E. CLAY SHAW, Jr., Florida
DON SUNDQUIST, Tennessee
NANCY L. JOHNSON, Connecticut

Robert J. Leonard, *Chief Counsel and Staff Director*
Phillip D. Moseley, *Minority Chief of Staff*

# CONTENTS

Page
Press release of Wednesday, March 22, 1989, announcing the hearing 2

## WITNESSES

Congressional Budget Office, Robert D. Reischauer, Director 123

American Business Conference, George N. Hatsopoulos 63
American Council for Capital Formation, Margo Thorning 160
Association of Private Pension and Welfare Plans, Howard C. Weizmann 378
Bosworth, Barry P., Brookings Institution 4
Christian, Ernest S., Jr., Patton, Boggs & Blow, Washington, DC 143
Citizens for Tax Justice, Robert S. McIntyre 171
College Savings Bank, Princeton, NJ, Peter A. Roberts 96
Fidelity Investments, Boston, MA, Robert C. Pozen 107
Hatsopoulos, George N., American Business Conference 63
Heinz, Hon. John, a U.S. Senator from the State of Pennsylvania 57
Heclo, Hugh, George Mason University 230
Insurance Coalition of America, Inc., John D. Regan 367
Kotlikoff, Laurence J., Boston University 19
Levine, Hon. Mel, a Representative in Congress from the State of California 278
Makin, John H., American Enterprise Institute for Public Policy Research 29
McIntyre, Robert S., Citizens for Tax Justice 171
National Retail Merchants Association, Thomas E. Swanstrom 223
Pechman, Joseph A., Brookings Institution 223
Pozen, Robert C., Fidelity Investments, Boston, MA 107
Regan, John D., Insurance Coalition of America, Inc 367
Roberts, Peter A., College Savings Bank, Princeton, NJ 96
Roth, Hon. William V., Jr., a U.S. Senator from the State of Delaware 50
Securities Industry Association, John L. Steffens 111
Shoven, John B., Stanford University 238
Steffens, John L., Securities Industry Association 111
Summers, Lawrence H., Harvard University 249
Swanstrom, Thomas E., National Retail Merchants Association 151
Tauzin, Hon. W.J. (Billy), a Representative in Congress from the State of Louisiana 271
Thorning, Margo, American Council for Capital Formation 160
Weizmann, Howard C., Association of Private Pension and Welfare Plans 378

## SUBMISSIONS FOR THE RECORD

American Association of Retired Persons, statement 387
American Council of Life Insurance, statement 395
Center on Budget and Policy Priorities, Robert Greenstein, statement 400
Fisher, George Ross, M.D., Philadelphia, PA, statement 406
Tax Council, statement 409

# NATIONAL SAVINGS RATE OF THE UNITED STATES AND ITS TRADING PARTNERS

WEDNESDAY, APRIL 19, 1989

House of Representatives,
Committee on Ways and Means,
*Washington, DC.*

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

[The press release announcing the hearings follow:]

FOR IMMEDIATE RELEASE
WEDNESDAY, MARCH 22, 1989

PRESS RELEASE #11
COMMITTEE ON WAYS AND MEANS
U.S. HOUSE OF REPRESENTATIVES
1102 LONGWORTH HOUSE OFFICE BUILDING
WASHINGTON, D.C. 20515
(202) 225-1721

# THE HONORABLE DAN ROSTENKOWSKI (D., ILL.), CHAIRMAN, COMMITTEE ON WAYS AND MEANS, U.S. HOUSE OF REPRESENTATIVES, ANNOUNCES A SERIES OF HEARINGS TO CONSIDER LONG TERM STRATEGIES FOR PROGRAMS AND ISSUES WITHIN THE JURISDICTION OF THE COMMITTEE

---

The Honorable Dan Rostenkowski (D., Ill.), Chairman, Committee on Ways and Means, U.S. House of Representatives, today announced that the Committee will hold a series of hearings to consider long-term strategies for programs and issues within the jurisdiction of the Committee.

The first hearing in this series will examine the national savings rate of the United States and its trading partners, and will be held on Wednesday, April 19, and Thursday, April 20, 1989, in the Committee's main hearing room, 1100 Longworth House Office Building, beginning at 10:00 a.m. each day.

In announcing these hearings, Chairman Rostenkowski stated: "The Congress and the Administration are too often consumed with responding to the issues and problems of the moment. We rarely take the time to look beyond the next budget cycle or the next reconciliation bill. Legislating only for the short term, and often in a crisis atmosphere, is becoming too common a practice. Our collective inability to step back and take a longer view has contributed to some of the economic and social problems that we face today.

"The committee process should allow Members the opportunity to consider issues in a context other than fiscal emergencies or budget deadlines. To this end, the Committee on Ways and Means will undertake a series of hearings to examine current demographic, economic and social trends, and their potential impact over the next decade on programs within the Committee's jurisdiction. I want to emphasize that the hearings are not being held to further any particular legislative agenda. Their goal is to encourage Members, and witnesses alike, to consider a number of difficult issues without regard to today's political climate or the latest poll.

"The first of these hearings will consider our national savings rate and its implications for the long-term health of our economy and future standard of living. In addition to testimony from the public, invited witnesses will be asked to examine trends in our savings rate over time; comparisons to other countries; reasons for our current low savings rate; and the implications for future investment and economic growth. In addition, the Committee will examine the level and distribution of U.S. income and tax burdens, and comparisons with our trading partners.

"Subjects for future hearings on long-term strategies and long-term perspectives are expected to include the budget deficit, foreign investment in the United States, trade policy, issues involving children and the family including preparation for participation in the work force, retirement income, health care, energy security, infrastructure, and the environment. This is not meant to be an exclusive list, but only illustrative of the kinds of issues that the Ways and Means Committee needs to be thinking about as we look ahead to the 1990s and beyond. I anticipate close coordination with and follow-up hearings by appropriate subcommittees of jurisdiction as the full Committee moves forward in examining these important issues.

"The structure of these hearings makes them something of an experiment for a congressional committee. I'll consider them a success if, for only a few hours every month or so, we can stop counting votes, plotting short-term actions, and consider the social and economic world we're leaving the next generation."

Specific dates and times for additional hearings will be announced in subsequent press releases.

## DETAILS FOR SUBMISSION OF REQUESTS TO BE HEARD:

Individuals and organizations interested in presenting oral testimony before the Committee must submit their requests to be heard by telephone to Harriet Lawler or Diane Kirkland [(202) 225-1721] no later than Wednesday, April 7, 1989, to be followed by a formal written request to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. The Committee staff will notify by telephone those scheduled to appear as soon as possible after the filing deadline. Any questions concerning a scheduled appearance should be directed to the Committee staff [(202) 225-1721].

It is urged that persons and organizations having a common position make every effort to designate one spokesperson to represent them in order for the Committee to hear as many points of view as possible. Time for oral presentations will be strictly limited with the understanding that a more detailed statement may be included in the printed record of the hearings. (See formatting requirements below.) In addition, witnesses may be grouped as panelists with strict time limitations for each panelist.

In order to assure the most productive use of the limited amount of time available to question hearing witnesses, all witnesses scheduled to appear before the Committee are requested to submit 200 copies of their prepared statements to the Committee office, room 1102 Longworth House Office Building, at least 24 hours in advance of the scheduled appearance. Failure to comply with this requirement may result in the witness being denied the opportunity to testify in person.

## WRITTEN STATEMENTS IN LIEU OF PERSONAL APPEARANCE:

Persons submitting written statements for the printed record of the hearings should submit at least six (6) copies of their statements by the close of business on Friday, May 19, 1989, to Robert J. Leonard, Chief Counsel, Committee on Ways and Means, U.S. House of Representatives, 1102 Longworth House Office Building, Washington, D.C. 20515. If those filing written statements for the record of the printed hearings wish to have their statements distributed to the press and the interested public, they may provide 100 additional copies for this purpose to the Committee office before the beginning of the hearings.

## FORMATTING REQUIREMENTS:

Each statement presented for printing to the Committee by a witness, any written statement or exhibit submitted for the printed record or any written comments in response to a request for written comments must conform to the guidelines listed below. Any statement or exhibit not in compliance with these guidelines will not be printed, but will be maintained in the Committee files for review and use by the Committee.

1. All statements and any accompanying exhibits for printing must be typed in single space on legal-size paper and may not exceed a total of 10 pages.
2. Copies of whole documents submitted as exhibit material will not be accepted for printing. Instead, exhibit material should be referenced and quoted or paraphrased. All exhibit material not meeting these specifications will be maintained in the Committee files for review and use by the Committee.
3. Statements must contain the name and capacity in which the witness will appear or, for written comments, the name and capacity of the person submitting the statement, as well as any clients or persons, or any organization for whom the witness appears or for whom the statement is submitted.
4. A supplemental sheet must accompany each statement listing the name, full address, a telephone number where the witness or the designated representative may be reached and a topical outline or summary of the comments and recommendations in the full statement. This supplemental sheet will not be included in the printed record.

The above restrictions and limitations apply only to material being submitted for printing. Statements and exhibits or supplementary material submitted solely for distribution to the Members, the press and public during the course of a public hearing, may be submitted in other forms.

Chairman **Rostenkowski**. Good morning. Today, the committee will begin a series of hearings that I hope will lead us to shift our focus of thinking as we design policies and programs within the jurisdiction of the Committee on Ways and Means.

Too often we direct our legislation to short-term concerns attempting to provide a solution that will have immediate effects. We are consumed by crisis situations and budget deadlines, such that we rarely have time to look at the long-term issues. The politics of the vote are often at odds with long-term policy concerns.

If we continue to legislate reactively rather than preventively, we will eventually be faced with some very serious problems. It is time for Congress and the committee to look at this present situation in a long-term context and take this into account when we consider legislation before the Ways and Means Committee.

In this light, I have scheduled a series of hearings on long-term strategies for programs within this committee's jurisdiction. In developing policy the committee should have a sense of what its role should be beyond the net budget cycle and the next reconciliation agreement. We should focus on our policy goals for the next 4, 8, or even 10 years.

I want to stress that there is no specific legislative agenda dictating these hearings. I encourage the members of this committee to stop counting votes and polling constituents for a moment and listen to these witnesses with an open mind and with concern for the future of the country.

For the next 2 days we will hear testimony on two related issues: the national savings rate and income distribution. Our savings rate has declined steadily during the economic boom of the eighties. It is now at its lowest point since World War II. Although our economy still seems strong, the consequences of prolonged low savings rate could be serious for long-term economic growth and the welfare and standard of living of our children and grandchildren.

This morning Barry Bosworth, from the Brookings Institution, Larry Kotlikoff, from Boston University, and John Makin, from the American Enterprise Institute, will testify on the long-term implications of our declining national savings rate.

Gentlemen, I welcome you to the committee and I am looking forward to your testimony. If you are ready and you know the rules—I think you have testified here before—we ask that you summarize your statement if it is in excess of 7 minutes and at the conclusion of your testimony, we will engage in some exchange with the committee members.

Mr. Bosworth, if you are ready to begin your testimony, the committee is ready to receive it.

## STATEMENT OF BARRY P. BOSWORTH, PH.D., SENIOR FELLOW, THE BROOKINGS INSTITUTION

Mr. **Bosworth**. Thank you, Mr. Chairman. I do have a prepared statement, so I will just try to say a few words about it.

I think the easiest way to begin is with table 1 of my testimony. It provides data on what are recent trends in the U.S. national saving rate.

As you can see there, the United States has suffered in the 1980's a dramatic decline in the national saving rate. On our national income accounting basis, we were saving in the range of about 8 percent of our national income in most of the post-World War II period. In the 1980's, that rate has declined to an average of about 3 percent. In other words, the national saving rate has more than fallen in half.

We have historically been one of the world's low savings rate countries. We are the richest country mainly because we haven't had a war on our own shores in about 100 years, so we haven't destroyed what little wealth we do create each year. But there has been a dramatic decline that shows up in the data in the 1980's. I think in looking at that, about half of the decline is due to a decline in the private saving rate and about half is due to a dramatic increase in the size of dissaving on the part of the Federal Government.

For example, the Federal Government has been borrowing half of all private saving in the United States just to finance the budget deficit, leaving us with about 3 percent of our national income left over to finance capital formation here in the United States.

The other dimension that shows in the table, is that investment has stayed relatively high. We have a baby boom generation, for example, that would like a chance to buy a house, like the rest of us, so home building demands have been very high in the 1980's, and we went into the decade with what most American businessmen thought was a highly outdated capital stock and the demand for business investment has stayed fairly high in the United States, although not as good as it was in the sixties and seventies.

Thus, as a country, we have been saving 3 percent of our national income, but we have been investing 6 percent of our national income. Now, simple arithmetic says you have a problem if you only save 3 and invest 6, and the United States has been making up the difference by borrowing 3 percent of our income overseas from foreign investors to try to finance about half of American capital formation.

The gap between saving and investment is being covered by the inflow of funds from abroad, or what most Americans identify as a current account deficit with the rest of the world. I would only want to point out in that respect, the United States primarily runs a trade deficit with the rest of the world not because we can't compete in world markets, but more because the United States saves so little it is forced to borrow overseas to support current standards of living.

All you would have to imagine, for example, is what would happen if suppose we sealed our borders and passed a law that we couldn't have a current account deficit and we couldn't borrow from overseas. U.S. interest rates would soar to record levels and current baby boomers buying houses would be forced out of capital markets. In other words, I would characterize the situation in the 1980's as the United States has become a country living way beyond its means, selling of our national assets inherited from previous generations at the rate of about $150 billion a year to support our own consumption here in the United States.

In turning to the causes of that, let me say a few things about the decline in the private savings rate. It is a surprise, I think, to most economists, because we have been used to thinking of a low, but very consistent savings rate. In fact, there used to be something called Denissen's Law that said the private saving rate was always a constant in the United States.

In trying to explain why it declined in the 1980's, I gave you a chart that shows household saving in more detail, particularly in figure 2, which focuses on the decline in the household savings rate. It is the decline in household savings, as opposed to corporate savings, that accounts for most of the fall in the private savings rate.

Today, nearly all of household saving is in the form of retirement accounts. Discretionary saving has essentially fallen to zero. What little saving households do now is done for them by their employers in the accumulation of pension fund reserves.

In fact, the pension fund reserves account for some of the funny cycle that we have had in savings recently, because pension funds saving in the 1980's has also fallen dramatically. The reason relates to the tax laws. In the mid-1970's we passed something called the ERISA law, which required pension funds to meet minimum funding requirements for their future liabilities. Most of the funds were underfunded. In the last half of the 1970's there was a big inflow of funds into the pension funds trying to bring them up to the Government minimum standards and the savings rate actually was held up by this phenomenon for about 5 years.

In the 1980's, though, these pension funds have observed extremely high market rates of interest. If you are an actuary and you use those discounts rates to evaluate future liabilities, you now assume you can cover your liabilities by earning a very high rate of interest on existing reserves. As a result, for tax purposes, over half of all American pension funds are now overfunded and it is illegal under the tax law to contribute as an employer, to a pension fund that is overfunded. That has resulted in some decline in the inflow of funds into private pensions.

However, the basic conclusion I want to make is that we don't understand fully all the reasons for the decline in discretionary saving. We have been through a half a decade of experience with various Government incentives to encourage private saving. I think we have to conclude that basically they failed.

There is really not much the Government can do to make people save money outside of coercion. Therefore, in trying to set targets for the national savings rate, I would urge that we attempt to achieve those targets through changes in the saving from a national level through the public sector saving—the budget balance—rather than incentives for private saving that probably won't work. It seems a little silly for the Federal Government to criticize private sector individuals for not saving enough when it runs a budget deficit of $160 billion and seeks to encourage them to save more so it can borrow it.

I think if we want to increase the national savings rate in this country or here in Washington, there is a very simple way to do it and that is, cut the budget deficit. It is just that that is an extremely unpopular political idea, because while we all agree that the budget deficit is terrible, even worse than the budget deficit would be to do something about it, because it would mean an increase in our taxes and a cut in our favored expenditure programs.

But I think realistically that economists really don't have much to say to you in terms of raising the national savings rate except if Government wants to do it, Government has to start by reducing its own dissaving, and criticizing individuals in the private sector for saving too little in the present economic atmosphere, strikes me as somewhat absurd.

Thank you.

[The statement of Mr. Bosworth follows:]

Testimony of

Barry P. Bosworth*

before the

Committee on Ways and Means
House of Representatives
United States Congress

April 19, 1989

I appreciate this opportunity to appear before the Committee to discuss some of the implications of the decline in the national saving rate, and the strategies that might be adopted to reverse it. The extent of the decline during the 1980s is shown in table 1 which presents the basic national accounts data for the period of 1950-80. The U. S. net national saving rate has averaged about 3 percent of income during the 1980s, compared to 7-8 percent in prior decades--a decline of more than 50 percent. It is, I believe, fair to characterize the United States as a nation on a consumption binge.

In the table I have divided national saving between public and private saving. Private saving includes the saving of households (income minus consumption expenditures) plus the retained earnings of corporations. Government saving (tax income minus expenditures) has generally been negative for the United States in the post-World War II period, but the magnitude of the deficit has increased greatly in the 1980s. What we observe is that the decline in international saving during the 1980s reflects both a decline in the private saving rate--from about 9 percent of income to 7 percent; and an increase in public dissaving--the budget deficit--from 1-2 percent of income to 3-4 percent.

In 1988 the private-sector saving rate was 6.7 percent of income. The government borrowed a little more than half of that (3.6 percent) leaving 3 percent of the nation's income to finance investment in business plant and equipment and residential housing. Since actual investment totaled 6.1 percent of income, the United States was forced to borrow about 3.1 percent of its income in international markets--the current account deficit. In other words, if you save 3 percent of your income and invest 6 percent, simple mathematics says that you must borrow 3 percent overseas through a combination of issuance of debt and sales of assets. In 1988 that net borrowing from abroad totaled about $136 billion.

I would like to address some of the issues in the current debate under four basic headings: (1) arguments over the measurement of saving, (2) implications of the decline, (3) causes of the decline, and (4) actions that might be taken to reverse it.

## Measurement Issues

Much of the current debate gets tangled up in issues of how to measure saving or misleading comparisons to other countries. First, the numbers shown in table 1 measure saving on a net saving basis, exclusive of the saving required to replace existing capital, depreciation or capital consumption allowances as it is called in the national accounts. On a gross basis the private saving and investment rates would be raised by about 10 percentage points. Also, the decline in saving during the 1980s is smaller when we use gross saving because there has been a shift in the pattern of investment in the United States toward shorter-lived capital, raising capital consumption allowances as a percent of income. For purposes of wealth accumulation we should be interested in the net saving rate, but for some analytical purposes the gross rate is more appropriate.

---

*Barry Bosworth is a Senior Fellow at the Brookings Institution. The views expressed in this statement do not necessarily reflect those of staff members, officer, or trustees of the Brookings Institution.

Second, some economists will attempt to minimise the contribution of government to the decline in national saving by including the accumulation of *reserves in funded public employee pension plans* as part of government saving, even though private pension accumulation is credited to household saving in the national accounts. This is not a big issue for the federal government because reserves are not being set aside, but it amounts to $65 billion for state and local governments in 1988. In table 1, I credited that saving to the private sector, leaving state and local governments with a small overall budget deficit. If you don't agree with that treatment, reduce the private saving rate by 1.5 percentage points in the 1930s and raise government saving correspondingly.

Third, because the measurement of saving requires agreement on how to classify a nation's saving between consumption and investment, it is possible to change its level by changing the *definition of saving*. The three major areas of dispute are: consumer durables, education outlays, and research and development. Since the United States spends heavily in all three of these areas, the international comparisons are affected by the classification of these outlays as consumption. These issues are dealt with in a recent book by Robert Lipsey and Irving Kravis that I would recommend to the committee.[1] However, for our purposes the important point is that these potential reclassifications would raise the relative level of saving in the United States historically, but they slightly accentuate the decline of the 1980s; and, adjusted for depreciation of these assets, the overall effects are small.

Fourth, the U. S. national accounts do not incorporate a *capital budget for the government*--classifying all government purchases as consumption. Such calculations can be made and the United States does so in the version of the national accounts published by the United Nations and the Organization of Economic Cooperation and Development (OECD). Again, the effect is to slightly raise the level of net national saving and investment, but it *increases* the magnitude of decline--government capital outlays have born the brunt of the budgetary cuts in the 1980s. It should be also noted that the international standards do not include military hardware in the category of productive capital.

Finally, some economists argue in favor of a completely different measure of saving based on the change in the *market value of wealth*--including capital gains and losses. That is done, for example, in the tax code when we include realized capital gains in taxable income. Such a measure gives quite a different picture of private saving because it essentially adds capital gains or losses to the standard concept. This alternative measure has huge year-to-year variance, going up and down with the stock market and it has some effect on the trend. Over the whole 1960-88 period, real capital gains have averaged close to zero, but there were huge losses in the 1974-75 period and in the early 1980s, and much of the prior loss was recovered in the mid-1980s (see figure 1).

While I would agree that capital gains are important for evaluating the net welfare of individuals and most economists would include capital gains and losses as one of the determinants of private saving, it is not a useful measure of saving for most economic purposes. Our primary interest in national saving is in measuring the amount of a nation's output that it sets aside to use to increase future incomes, the increment to *productive* wealth. While long-term fluctuations in the stock market may be useful indicators of future changes in technology and other factors that affect economic growth, we do not want to lump all these effects together--particularly when short-term market changes are so volatile and driven by speculative factors.

Furthermore, changes in markets values of capital often have nothing to do with the measurement of a nation's productive wealth or future income. For example, if innovation came to an end, the market value of existing firms would soar--there would be no obsolescence of existing capital, but future national income would not. Nor is the soaring value of land in Tokyo a particular blessing to the Japanese.

---

[1] Robert E. Lipsey and Irving B. Kravis, *Saving and Economic Growth: Is the United States Really Falling Behind?* (New York: The Conference Board, 1987).

There is also a wide range of issues that, while they do not alter national saving, they do have a big impact on its division between the public and private sector. For example, as Robert Eisner suggests, we might adjust the government budget for the effects of inflation. In a world of high inflation, some of the interest payment on government debt reflects a repayment of debt principal rather than interest income. Thus, if we made such an adjustment, it would reduce the government deficit with an equal offsetting reduction in private incomes and saving. Ignoring foreign debt, national saving would be unaffected. That adjustment would greatly alter the level of the budget deficit in the 1970s, but it actually makes the trend of the 1980s even worse because the inflation rate has declined. It may, however, be important for understanding private saving behavior if bondholders realize that a 10 percent rate of interest is not an attractive rate of return when inflation is also 10 percent. Thus, many economists would include inflation as a determinant of private saving without going so far as to assume that it is immediately understood by all bond holders.

Furthermore, existing government budget concepts may be very misleading because of their failure to account for the future costs of commitments made today. The current budget does not include the present value of future liabilities to private individuals or the accumulation of reserves to meet those liabilities, examples being social security and the various loan subsidy and guarantee programs. Yet, if private individuals take account of those promises in their own saving plans, the national saving rate may be adversely affected if government reserves are not increased to offset the decline in private saving. This is an important issue, but it is also a morass. I believe that the general view of the economics profession has been that it is increasingly important to take account of the major elements of future government liabilities if we hope to understand private saving behavior.

### Economic Implications

The implications of a low national saving rate is an issue on which there is also an enormous diversity of opinion within my profession, primarily because economists use different analytical models to evaluate the effects of changes in national saving.

First, we must be careful to not draw too close a connection between national saving and investment. As we move toward an integrated world capital market, the connection between the two is breaking down. Firms that produce and invest in the United States may come not to care that they operate in an economy with low saving. If capital is free to move across national boundaries, domestic saving does not constrain domestic investment; saving is allocated according to worldwide opportunities while domestic investment draws from that same pool for its financing. Thus, a shortage of domestic saving is reflected in net capital inflows--a trade deficit--rather than reduced domestic investment. When firms borrow to finance investment, they do not care where the money comes from.

It is also clear that we are not there, yet; and the United States must offer significantly higher rates of interest to attract foreign capital, thus placing American firms at a financing disadvantage vis-a-vis their foreign competitors. Japanese firms can finance investment with a much lower interest rate than American firms.

Some economists also question the sustainability of the current net inflow of foreign capital and forecast a financial crisis associated with a collapse of the exchange rate. I would be more sanguine for the near future. It may be unwise for a society to reduce its saving and live off the wealth accumulated by past generations; but it seems to me that there is nothing in the operation of economic markets that prevents it, any more than it prevents the descendants of John D. Rockefeller from consuming his wealth. Perhaps the current pattern of foreign borrowing to support consumption can not last forever, but I would not challenge the bet of this administration that it can last for four more years.

Third, some members of my profession worry that an increase in saving could simply lead to a fall in demand and a recession. I would agree if the change was sudden and large; but that is not the realistic option of the current debate. We have extremely high interest rates today suggesting that there is a lot of pent-up investment demand--perhaps reflecting the fact that the baby-boom generation would like the opportunity to own a home like the rest of us. If a gradual increase in the inflow of saving into capital markets were matched by a reduction in interest rates, I believe the evidence suggest that it could be absorbed in higher investment.

In addition, the United States could absorb a 3 percentage point increase in national saving with no need to increase domestic investment. It simply ceases to borrow in foreign markets, reverting to the pattern of living within its own means that it followed prior to the 1980s. That assumes a willingness to allow U. S. interest rates and exchange rates to decline to the point that a surplus of exports over imports could meet the net interest payments on the foreign-held debt. Again, if attempted over a short time-period, that could be highly disruptive to the United States and the world economy, but it could be absorbed on a multi-year basis.

We should worry about a low rate of national saving, even in a world of fully mobile capital international, because of its implications for a slow growth of the incomes of future generations. This cannot be pictured as a catacylsmic process, however. Certainly, in the short run, a spending binge is a lot of fun, as we all know from personal experience. We should not be surprised that many Americans think the 1980s has been the best of times. A few years of low saving has very little implication for a nation with an estimated $15 trillion of accumulated wealth, but over a sustained period, lower wealth accumulation will reduce income growth; and, even if capital investment continues, most of its benefits will accrue to its foreign owners. My colleague at Brookings, Charlie Schultze, has characterized the present low saving rate as comparable to termites in the woodwork. However, do Americans really believe that, in an increasingly competitive world economy, nations that save 3 percent of their income can compete effectively with nations that save 10 percent.

I also believe that the empirical studies strongly suggest very high rates of return to the nation from increased capital formation. They are in the range of 8 percent for physical capital, 10 percent for education and perhaps in excess of 15 percent for research and development.

## Sources of Declining Saving

The decline in national saving can be about evenly split, using national accounts data, between a decline in private saving and an increase in government dissaving. In an earlier paper, I examined some of the potential explanations for the decline in private saving. Thus, I will only summarize my conclusions here:

- The decline in the private saving rate is concentrated in the household sector; and, if we adjust for some effect of capital gains and losses, it appears to have begun in the mid-1970s rather than being a recent phenomenon.
    - The extent of decline is only minimally affected by changing the definition of saving or adjusting for inflation.
- The overwhelming portion of household saving is in the form of pension fund accumulation and pension funds are a source of part of the decline in the saving rate (see figure 2). However, the largest decline is in nonpensions or discretionary saving.
    - The proportion of the workforce covered by pensions has not been rising in recent decades.
    - The use of today's high market interest rates to discount future pension liabilities has driven many of the funds into an over-funded status; and current tax laws lead employers to cut back on their own contributions. This reduction in pension contributions appears to account for as much as one percentage point of the decline in the private saving rate.
    - Pension funds are also an ideal example of target-saving behavior in which increases in the expected rate of return actually lead to a reduction in the saving rate. Since the target is a fixed pension payment, a higher rate of return

virtually reduces the rate of saving required to achieve it.

-- On the basis of aggregate data, Investment Retirement Accounts (IRAs) do not appear to have stimulated overall saving. Instead, there appears to have been a major shift in the allocation of existing saving between taxable and nontaxable accounts. (I will return to this issue).

o I am also skeptical that demographics are an important part of the story. Most advocates of this view focus on a small segment of the population such as the baby-boomers. However, studies that try to account for the whole age distribution and the proportion of income they earn consistently find that the demographic trends do not match well with the observed saving rate trend. The proportion of total income accounted for by 45-65 year-olds (the high savers) fell steadily from 1950 to 1980, while the proportion of the population that was very young or retired was rising. Yet, the overall saving rate remained very constant. Now that the age parameter has reversed in the 1980s and led us to expect higher saving, the actual rate has declined. Demographics is a thin reed on which to hang expectations of a future increase in the saving rate.

o Our ability to explain the decline in U. S. saving rates has also been confounded by the divergency of saving trends in other countries. Some countries, such as Canada and the United Kingdom, had large increases followed by a sudden collapse, while others show little change. At present, we have not been able to develop a consistent explanation that applies to all situations or to explain the exceptions.

o Finally, if the sole objective of saving is to provide for an adequate retirement, Americans are not doing badly. Through a combination of social security and medicare, private pensions, personal saving, and transfers from their children, most retirees maintain a level of consumption that compares favorably with the retired of other countries. And, since the U. S. retirement system is not more generous than those of other countries, social security cannot be the sole explanation. It seems to me that the large international differences in saving rates must reflect important cultural differences in attitudes toward intergenerational transfers.

o My best guess is that the private saving rate will remain in future years within its current range of 6-7 percent. I must emphasize, however, that it is a guess based largely on the historical stability. The existing analysis simply does not provide a basis for doing much better than projecting a continuation of present levels.

The major blame for the decline in the national saving must lie with the government. Some progress was made in reducing the budget deficit after 1986, but it is now clear that we are stuck on a new plateau of annual deficits near $150 billion. I also believe that this reported deficit understates the magnitude of the problem, because the Congress and the Administration have cooperated in recent years to move the bad news outside the budget and to keep the good news in. There is also a consistent tendency to minimize the future problem by adopting overly-optimistic economic projections.

The practice of keeping the good news inside the budget is particularly evident with respect to the retirement accounts where we count the revenues, but ignore the future liabilities to which they are supposedly dedicated. I have summarized in table 2 an alternative view of the budget that separates the retirement and operating budget accounts. The overall story that the deficit will decline in future years is true only if you believe that its perfectly alright to borrow from the retirement accounts to finance current operating expenses. In effect, the government is not saving these reserves; it is using a regressive tax on low-wage workers to finance current consumption programs.

On the basis of the data in table 2, it also is clear that the budget deficit will not go away by itself. It is steadily expanding even on a current services basis. CBO projects the overall current services deficit (inclusive of the retirement accounts) to decline to $130 billion in 1994, only by assuming that total expenditures will drop by a full one percent of GNP. And the operating budget deficit will still grow to $307 billion. Even that target will be difficult to achieve given the growing pressures for new programs and the expansion of old programs as part of a "kinder and gentler America." Compared to 1980, there has been an astounding change in the structure of the budget as we move toward annual surplus in the retirement accounts of $175 billion in 1994, and then borrow those reserves to finance current outlays.

Policy Measures

Realistically, efforts to increase the national saving rate should be focused around efforts to increase government saving. Present discussion of various tax incentives to promote private saving serve mainly to direct attention from the more immediate problem of the government budget deficit.

- I see no reason to expand private saving if the government simply turns around and borrows it to finance its own deficit.
- Tax incentives for private saving cost the government revenue and increase its deficit. Thus, unless individuals save more than the tax--a bang-for-the-buck greater than 1.0--national saving is unchanged or even reduced. Since I don't believe the evidence indicates that these programs generate new saving, I am skeptical of their value.
- At present, there is a disagreement between the aggregate data on the contribution of IRAs and the survey data on individual households. I believe that the primary effect was to divert savings that already existed in other accounts, or would have been done by high-income, middle-aged families in IRA accounts. When IRAs expanded after 1981 other forms of saving declined, and when they were cut back in 1987, other forms of saving went up (see figure 2). Other economists disagree, however, and argue that the offsetting aggregate pattern reflects a coincidental change in other factors. And, they point to some surveys of individual households that imply that those with IRAs saved more.
- I fully agree that people with IRAs will have higher saving rates than those without IRAs. Ownership of an IRA is one of te best distinguishing characteristics between savers and dissavers, but that doesn't mean that an IRA leads savers to save more than they otherwise would--particularly when the ceiling limit is low. With existing data, it has been very difficult to fully resolve this issue.
- The basic problem of saving incentives seems to be that most individuals are saving for a fixed target like retirement. When the after-tax return rises, they actually need to save less to meet their goal. Some people do raise their goals, but not enough to alter total saving significantly.
- We see this in the 1980s when market rates of return of saving were far higher than before, marginal tax rates were reduced, and financial deregulation extended access to high-return investments to many more people. Yet, the overall saving rate declined.

I would approach the saving issue by setting targets for the budget balance of government on the basis of national saving and investment needs. It is simpler and more efficient to achieve national saving objectives through the public sector rather than using private saving incentives whose effects are highly uncertain. An example is provided in table 3. A reasonable goal for domestic investment would be to restore it to the 7.5 percent of income that we managed in prior decades. With a projected slowing of the labor force, this wold imply a significant acceleration of the growth in capital per worker. Second, a rich country, such as the United States, should as a minimum live within its means and not borrow overseas. The elimination of the current account deficit would require a target national saving rate equal to the 7.5 percent of income assumed for domestic investment. If the private saving rate stays in the range of 6-7 percent of income, the implied goals for the federal budget would be a surplus of about one percent of national income. If, as some of the optimists argue, the private saving rate should drift back up in future decades, that budget target would be reduced.

On the other hand, an equally valid argument could be made that we should aim for a target above the historical averaging in anticipation of the future costs of a larger retired population. In a recent study with some colleagues, I argued that the projected future increase in retirement costs could be covered with no increase in the burden on future workers by raising the national saving rate by 2 percent of national income.[2] It would also matter little if that increment to saving was invested domestically or overseas. We found that an addition to national wealth of that magnitude would generate sufficient income to meet the increase in consumption needs when the baby-boom begins to retire, without increasing the sacrifice of their children.

The government could articulate these goals publicly by explaining the need to aim for a budget surplus as opposed to the old pattern of small deficits. Or it can simply follow the practice of state and local governments and private firms of setting aside the retirement accounts. The government wold then focus its attention on adjusting the operating budget deficit about a long-run balance to meet its short-run stabilization objectives.

I would favor an accounting change, similar to that used by state and local governments that moved the retirement accounts outside the budget and credited any accumulation of reserves to private saving. I think that Social Security and Medicare have become deeply ingrained into private individuals' retirement planning, and that their financing has become too important to leave to the vagaries of short-run political pressures. They should be operated from here on like private pension plans, with contributions being increased whenever it is necessary to maintain long-run actuarial balance.

I agree that this issue is not substantive in that targets for fiscal policy can be stated as a surplus in the total budget (inclusive of the retirement accounts) or something approaching balance in the operating budget. I do believe, however, that it is easier to articulate publicly the need for increased national saving by separating the retirement and operating accounts.

At the same time, the argument that fiscal policy should focus on the total budget is basically irrelevant. The balance in the retirement accounts changes only slowly over time and is not a source of instability. Furthermore, short-run stabilization policy should be guided by the performance of the total economy. There is not any one level of the budget deficit that is "right" for stabilization policy. Plus, those economists who are interested in the total know how to add. I do believe the issues would be simplified for the Congress and the public if retirement fun revenues were not viewed as an appropriate source of financing of public consumption.

It is also possible that public-sector planning for future needs might be facilitated by the creation of a capital budget; but, unless done right, a capital budget can be a huge loophole that excuses government from acting. There is a tendency to want to shift every expenditure to the capital account and then fail to finance it. A useful capital budget requires strict adherence to rules that include provision for a depreciation fund and dedicated revenues to finance it.

---

2. Henry Aaron, Barry Bosworth, and Gary Burtless, Can America Afford to Grow Old? (Brookings Institution, 1988).

**Table 1. Net Saving and Investment as a Share of Net National Product, United States, 1951-88.**

Percent

| Item | Percent of Net National Product | | | | | | |
|---|---|---|---|---|---|---|---|
| | 1951-1960 | 1961-1970 | 1971-1980 | 1981-1985 | 1986 | 1987 | 1988 |
| Net Saving[a] | | | | | | | |
| Private saving[b] | 8.7 | 9.4 | 9.7 | 8.2 | 7.4 | 6.1 | 6.7 |
| Government saving | -0.7 | -1.0 | -2.0 | -4.6 | -5.3 | -4.1 | -3.6 |
| Total National Saving-Investment | 8.0 | 8.4 | 7.7 | 3.6 | 2.1 | 2.0 | 3.2 |
| Net foreign investment | 0.3 | 0.7 | 0.3 | -1.3 | -3.8 | -4.0 | -3.1 |
| Net domestic investment | 7.7 | 7.7 | 7.5 | 5.0 | 5.6 | 5.8 | 6.0 |

Source: United States Department of Commerce, United States National Income and Product Accounts, Bureau of Economic Analysis.

[a] Net saving and investment equal the gross flow minus capital consumption allowances (the depreciation of existing capital). Net National Product equals Gross National Product minus capital consumption allowances. The sum of the investment components does not add to total because of statistical discrepancy.

[b] Business and Household Saving. Employee pension funds of state and local governments are allocated to household saving to match the treatment of private pension funds.

Table 2. Projections of Baseline Federal Deficits, 1980-94

Billions of dollars

| | 1980 | 1989 | 1990 | 1991 | 1992 | 1993 | 1994 |
|---|---|---|---|---|---|---|---|
| **CBO FEDERAL DEFICIT** | -74 | -159 | -146 | -146 | -140 | -135 | -130 |
| Less Surplus in: | | | | | | | |
| Social Security (OASDI) (off-budget) | -1 | 56 | 68 | 79 | 90 | 103 | 117 |
| **CBO ON-BUDGET DEFICIT** | -73 | -214 | -214 | -225 | -230 | -238 | -247 |
| Less Surplus in: | | | | | | | |
| Medicare (HI) | 1 | 20 | 21 | 18 | 17 | 15 | 12 |
| Fed. Employ. Retirement[b] | 10 | 34 | 36 | 39 | 42 | 43 | 48 |
| **NONRETIREMENT BUDGET DEFICIT** | -84 | -268 | -271 | -282 | -289 | -296 | -307 |
| **GRH TARGETS** | n.a. | -136 | -100 | -64 | -28 | 0 | n.a. |

Source: Numbers for 1980, 1987 and 1988 are actual. Numbers for 1988 through 1993 are the Congressional Budget Office baseline projections from February 1989.

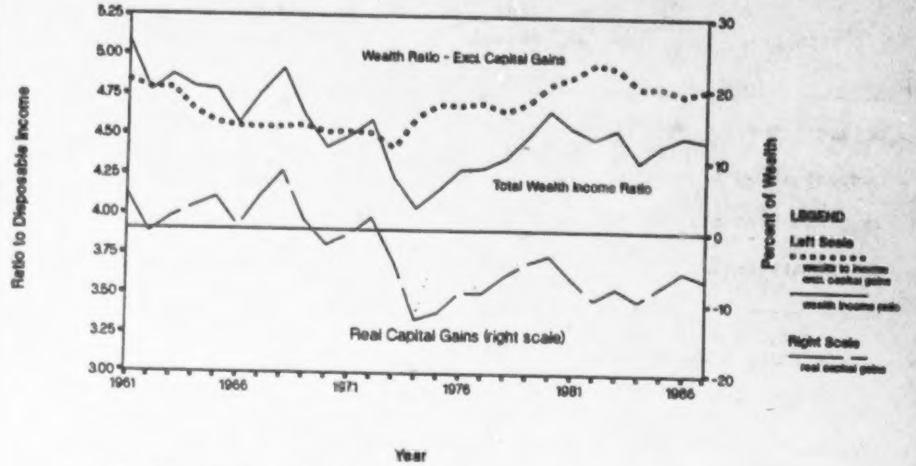
a. Sequestration is not required if the projected deficit exceeds the target but by less than the margin.
b. Includes civilian and military retirement trust funds.

Table 3. Illustrative Calculation of Target National Saving Rates

Percent of net national product

| Category | 1988 Actual | Mid-1990s Low | Mid-1990s Medium | Mid-1990s High |
|---|---|---|---|---|
| Domestic investment | 6.0 | 6.0 | 7.0 | 7.5 |
| Current account | -3.1 | 0.0 | 0.0 | 0.5 |
| Required national saving | 3.2 | 6.0 | 7.0 | 8.0 |
| Private saving | 6.7 | 7.0 | 7.0 | 7.0 |
| Budget total | -3.5 | -1.0 | 0.0 | 1.0 |
| Retirement accounts | 2.0 | 2.8 | 2.8 | 2.8 |
| Operating budget | -5.5 | -3.8 | -2.8 | -1.8 |
| Addenda: | | | | |
| Projected operating budget | | | | |
| Current services | | | -4.8 | |
| Gramm-Rudman-Hollings | | | -2.8 | |

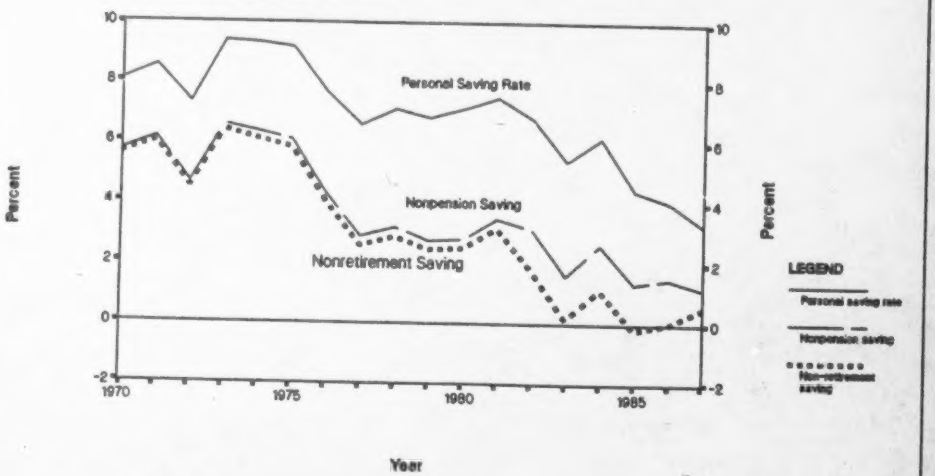
## Figure 1. Real Capital Gains on Household Wealth



Wealth excluding real capital gains is computed as the sum of saving in constant prices(consumer).

## Figure 2. Retirement and Nonretirement Saving

Percent of Disposable Income



Nonretirement saving excludes employer-financed pension accumulation and IRA and KEOGH contributions

Chairman ROSTENKOWSKI. Mr. Kotlikoff.

## STATEMENT OF LAURENCE J. KOTLIKOFF, PH.D., CHAIRMAN, DEPARTMENT OF ECONOMICS, BOSTON UNIVERSITY

Mr. KOTLIKOFF. Thank you, Mr. Chairman, members of the Ways and Means Committee.

I am grateful for the opportunity to discuss with you the Nation's very significant problem of undersaving. The most appropriate way to measure U.S. saving is to subtract private plus government consumption from our net national product and then divide by our net national product. This comprehensive savings rate measure tells us the fraction of the economy's net output that is put away each year to provide for the future. In constructing the net national savings rate it is important that we measure private and Government consumption correctly. Unfortunately, the national income and product accounts treat the purchase of durable goods by consumers as well as investment by the Government as direct consumption. This is clearly inappropriate. Households do not fully consume a newly purchased refrigerator in the space of 1 year. Similarly, the Government doesn't fully consume the services of a new machine or building it acquires in a single year, rather only that year's services from the new machine or building.

Table 1 in the back of my testimony presents the net national savings rate corrected for these problems of measurement and also presents the uncorrected measures.

You can see in table 2 that in comparison with the period 1950 through 1979, the national savings rate in the United States in the 1980's is about 60 percent of the level that prevailed in that 30-year period. If you look at the uncorrected measures, you also see a significant drop in the economy's national savings rate. So, whether you look at the corrected or uncorrected measures, you are getting the same picture, which is a significant decline in the national saving rate.

This is coming at a time when the United States is importing capital from abroad and saving at a rate lower than that of our trading partners. One of the things the table points out is that the corrected measures of saving are larger than the uncorrected measures. This is important when it comes to making international comparisons. Because the accounting procedures of other countries differ from that of our national income and product accounts one can easily misstate the differences between the U.S. savings rate and that of foreign countries.

For example, it is commonly believed that the Japanese are saving at a rate twice or three times as high as that in the United States. But if one does the same corrections that I have done here for the Japanese data—and this has been done by Professor Hayashi of the University of Pennsylvania—one finds the Japanese are saving more, but their saving rate is currently only about 50 percent larger than our own. The Japanese, by the way, have also experienced what appears to be a large decline in their saving rate in the eighties relative to the previous three decades.

Now, what explains the low U.S. rate? One explanation that can easily be dismissed is that it is due to increased Government consumption. If you look again at table 1, the third column has a measure G-hat over Y-hat. That is the corrected measure of Government consumption divided by the corrected measure of net national product. You can see there has been some increase in that ratio in the period 1980 through 1985 compared to the previous three decades. But the increase in Government consumption, properly measured, as a share of net national produce, properly measured is not large enough to explain much of the drop in our net national savings rate.

The real explanation for the decline in our net national savings rate comes from the private sector. If you look at the second column in this table, you see what I define as a private saving rate. This definition of the private saving rate is free of the accounting conventions.

Barry was just referring to private versus public saving. Economists, including myself, become very uneasy in making distinctions between private and Government sectors based on definitions of taxes and spending, which are economically not necessarily well defined. But the private savings rate in the second column in the table is a well defined economic concept. It considers the output that the country has left over after the Government consumes and asks what fraction of this residual output is the private sector not consuming?

We can see that that private savings rate, which again does not depend on arbitrary definitions of taxes or transfer payments, shows again a dramatic decline in saving behavior in the 1980's. Now, what has led the private sector to switch from consuming 80 cents of every dollar of national output left over after the Government has consumed to now consuming $9.18 of every left over after the Government consumed?

The answer many economists will give you, and the one you heard a few minutes ago from Barry, is that it is the Government's intergenerational policy, the shorthand for which is the deficit policy. Well, pointing the finger at the budget deficit is popular, a closer look at our intergenerational policy in the 1980's shows that much of what the Government gave current generations with its right hand, it took away with its left hand.

If you think, for example, about the 1983 Social Security amendments, they reduced in present value the benefits of the baby boom generation quite significantly. What they lost in present value corresponds, roughly speaking, to the gain they got from the Reagan tax cuts. So I, for one, do not believe there was a very significant generational policy, despite the fact that we did have those large reported deficits. Again, the reason we had those large reported deficits, to a certain extent, reflects our quite arbitrary accounting conventions.

Now, there are many economists who believe that the public is not very rational, that the public doesn't make intertemporal calculations and that the public lives on a cash-flow basis that they are liquidity constrained and consume everything they can get their hands on.

This is really the argument underlying the notion that the deficit is the cause of our low savings rate in the 1980's. There are a number of problems with this Keynesian argument. First of all, virtually every study I have seen shows that the fraction of American households that are consuming in this manner is only 20 percent at the most, and that these American households account for probably only about 10 percent of total consumption.

A second reason to doubt this Keynesian argument is that much of the growth in consumption expenditures in the United States is in the form of durables as opposed to nondurables and services. So what we see is spending by households that aren't liquidity constrained. If you are liquidity constrained, living hand to mouth, you are not going to buy a refrigerator. You are going to buy food.

The third reason why the argument doesn't square with the facts has to do with the composition of the reported deficit. If we take 1985 as an example, there was a $169 billion reported Federal deficit in that year—$130 billion of that number went for interest payments. The rest—$66 billion—is the excess of transfers over taxes.

Now, since liquidity constrained households—those living hand to mouth—obviously aren't bondholders, the key variable to consider with respect to their consumption is really not the total deficit, but simply transfers minus taxes. If one looks at that figure for the Federal Government in 1985 it is a $66 billion figure. If you look at the figure for total government, including Federal, State, and local governments, the net figure for transfers minus taxes is only $33 billion.

Well, the $33 billion is not peanuts, it is only about a fifth of the saving discrepancy that needs to be explained. If we had in 1985 the same saving rate we had on average between 1950 and 1980, we would have had roughly $200 or so billion more of saving. So $33 billion is a portion of $200 billion, but it is certainly not the whole picture.

So what else can explain this low private savings rate? Again, I do not agree that the deficit is the principal cause for the low saving rate. An alternative explanation has to do with the demographic transition. In 1950 the fraction of the population over age 65 was only 8 percent. The current figure is 12 percent. Over this period the fraction between ages 45 and 64 has been pretty stable. The faction of adults between 20 and 44 has increased slightly. So what we have is a relative increase in older and younger adults.

These are precisely the ages at which dissaving occurs. Young people don't start saving until they hit middle forties and older Americans are in the process of dissaving. So the demographics probably do explain part of the decline in saving, although I agree with Barry's testimony that indicates that demographics probably do not explain a large fraction of the decline in saving.

What else could be going on? Well, we have seen in the postwar period a very significant increase in insurance provision of a variety of types. The Government now provides disability insurance, unemployment insurance, survival insurance, earnings insurance through the progressive tax structure, and life span insurance through annuity provisions such as social security. It has old age insurance, nursing home insurance through Medicaid, and poverty insurance through its welfare programs.

Economic research suggests that each of these forms of Government insurance, while of very great economic value in and of themselves, can have the undesired side effect of very greatly reducing precautionary savings. Precautionary saving is a very significant determinative of total saving and we have seen a progressive increase in our insurance environment and that may be one of the things that is going on.

Another possible explanation for the decline in saving has to do with a reduction in the bequest motive. This may tie in with the fact that the birth rate in the United States is lower now than in the 1950's and 1960's. At least half and possibly as much as two-thirds of U.S. wealth can be traced not to life cycle saving for retirement, but rather to private bequests and other intergenerational transfers. It is hard to assess whether there has been a decline in the bequest motive for saving, but such a decline would not be surprising, given the general deterioration of the family in the United States, as evidenced by our high divorce rate and our low rate of the elderly living with their children.

Much of the saving associated with bequests that occurred prior to 1970 may have reflected the absence of annuity insurance. People may have died unexpectedly young and because they were not annuitized—their retirement resources were not in the form of annuities—they may have passed away and inadvertently left their money to the next generation.

Now that we have a lot more annuity insurance available through private pensions and Social Security, there is much less of these unintended bequests occurring in the economy and the counterpart of that is that people may be consuming more because they don't have to worry as much about living too long since they have their resources tied up in these annuities if they continue to live very long, they are not going to run out of cash.

Let me conclude with a couple of suggestions for what we might do at the Government level to turn this saving picture around. I should begin by saying that economists do not have a clear answer for why the saving rate is so low. I, for one, do not think that the deficit is really the explanation. So there is a puzzle here. So what can the Government do in the meantime, before we resolve this puzzle, to try and increase saving?

Well, I have three suggestions:

First, the Government could help publicize this problem—and certainly this hearing is going in that direction. The Government could also help in that manner by requiring all employers, as well as the Social Security system, to send workers annual statements indicating their accrued retirement benefits plus a calculation showing the amount of additional private saving required to reach an adequate level of total saving.

In other words, the Government could get involved in trying to counsel people about the fact that they may be doing too little saving. Baby boomers may not understand when they retire the benefits they are going to get from Social Security are not going to be as generous as those that their parents are receiving.

A second step the Government could take is to adopt a value added tax. Virtually all economists agree a consumption oriented tax structure would produce more saving than our income oriented tax structure.

A third step is for the Government to use a savings rate to target its fiscal policy. An increasing number of economists are questioning whether the reported deficit is a useful indicator of tight or loose fiscal policy. We see this concern about using the deficit in the whole debate about whether or not to include Social Security surpluses in the budget.

Under the guise of a balanced budget, the Government ran very loose fiscal policy in the 1970's when it expanded the Social Security system. Other policies, such as the Tax Reform Act of 1986, while having little or no implications for reported deficits, are also viewed by many economists as a loosening of the fiscal policy. Running tight fiscal policy involves putting a bigger burden on current generation. The tightening of fiscal policy should be gradual, but it should continue until the U.S. saving rate again reaches a level suitable to the world's premier economic power.

Thank you.

Chairman ROSTENKOWSKI. Thank you.

[The statement of Mr. Kotlikoff follows:]

# TESTIMONY OF LAURENCE J. KOTLIKOFF
## CHAIRMAN, DEPARTMENT OF ECONOMICS, BOSTON UNIVERSITY
## RESEARCH ASSOCIATE NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. Chairman and Members of the Ways and Means Committee:

I am grateful for this opportunity to discuss with you the nation's very significant problem of undersaving. The most appropriate way to measure U.S. saving is to subtract private plus government consumption from our net national product and then divide by net national product. This comprehensive saving rate measure tells us the fraction of the economy's net output that is put away each year to provide for the future. In constructing the net national saving rate it is important that we measure private and government consumption correctly. Unfortunately, the National Income and Product Accounts treat the purchase of durable goods by consumers as well as investment by the government as current consumption. This is clearly inappropriate: households do not fully consume a newly purchased refrigerator in the space of one year, rather they consume only the annual services of the refrigerator. Similarly, the government doesn't fully consume the services of a new machine or building it acquires in a single year, rather only that year's services from the new machine or building.

Table 1 presents the net national saving rate based on both the National Income Accounts measures of net national product, private consumption, and government consumption and corrected versions of these numbers. The corrected net national product measure adjusts the National Income Accounts measure of net national product by 1) adding the imputed rent on consumer durables and government tangible assets, excluding military equipment (expenditure on which is treated as current consumption) and 2) subtracting the depreciation on the stock of consumer durables and government tangible assets (excluding military equipment). Corrected private consumption equals private consumption expenditure on goods and services plus the imputed rent on consumer durables. Corrected government consumption equals the National Income Account measure of government consumption less government expenditures on (nonmilitary) equipment and structures, plus the imputed rent on government equipment (nonmilitary) and structures. The data used to correct the National Income Account figures come from the U.S. Department of Commerce's study entitled Fixed Reproducible Tangible Wealth in the United States, 1925-85.

Both the corrected and uncorrected measures of the net national saving rate show a marked drop in U.S. saving in the 1980s. According to the corrected measure, the U.S. saving rate averaged only 7.2 percent during the period 1980 through 1985. This average is about three fifths the corrected average saving rate of the 1970s and just over half the corrected average rate of the 1950s and 1960s. The corrected saving rate for the first half of the 1980s is indeed so low that it is even less than the average saving rate in the 1940s. While data are not available to calculate corrected saving rates since 1985, the uncorrected data suggests that the corrected rates for 1986 through 1988 are even lower than those in the first half of this decade.

The uncorrected measures understate the true rate of U.S. saving by roughly one third. This is a considerable difference and suggests the need for care in comparing U.S. saving rates with those of foreign countries, many of whom adopt different measures of net national product, private consumption, and government consumption. While a consistent comparison of corrected saving rates across a wide range of countries remains to be done, a recent study by Professor Fumio Hayashi of the University of Pennsylvania indicates that the Japanese net national saving rate, correctly measured, is currently roughly 50 percent larger than our own. The Japanese, by the way, are also experiencing a much lower saving rate in this decade than they did in the previous three decades.

What explains the low U.S. saving rate? One potential explanation that can easily be dismissed is that increased government consumption is to blame. Table 1 presents the ratio of government consumption to net national product. The corrected data indicate that the ratio of total government (federal, state, and local) consumption to NNP was only 7 percent larger during the first half of the 1980s than it was in from 1950 through 1970. It is easy to show that had the private saving rate in the 1980s remained at its average level for the period 1950 through 1980, the rise in the ratio of government consumption to NNP in the first half of the 1980s would have reduced the U.S. saving rate for the first half of the 1980s from .127, the average for the period 1950 through 1980, to only .124.

The private saving rate referred to here differs from conventional measures of private saving. It has the advantage of not being based on economically-arbitrary definitions of government "taxes," "spending," and the "deficit." My definition of private saving takes net national product less government consumption as the appropriate measure of disposable income for the private sector; it is the nation's output left over after the government has consumed. The private saving rate then asks what fraction of this disposable income is saved (not consumed) by the private sector; i.e., the denominator for the private saving rate is defined as net national product less government consumption, while the numerator equals this measure of disposable income less private consumption.

Table 1 presents corrected and uncorrected measures of this private saving rate. Regardless of whether one corrects the basic data for consumer durables and government investment, it is clear that the private saving rate has fallen dramatically in the 1980s. According to the corrected data, the private saving rate averaged 16.2 percent over the period 1950 through 1979. In contrast, from 1980 through 1985 the private saving rate averaged only 9.3 percent.

What has changed to lead the private sector, namely households, to switch from consuming 84 cents of every dollar of national output not consumed by the government to consuming 91 cents of every dollar of national output not consumed by the government? The answer many economists will give you is the government's intergenerational policy in the 1980s. The conventional argument is that by cutting taxes the government allowed current generations to consume more. While pointing a finger at the budget deficit is easy, a closer look at intergenerational policy shows that much of what the federal government gave current generations with its right hand during the 1980s, it took away with its left. For example, the 1983 Social Security amendments reduced the future benefits of current young and middle age generations by an amount, in present value, roughly equal to their gain from the income tax cuts.

Even if one doubts that the public makes the kind of rational, present value calculations that lead to the conclusion that generational policy was essentially neutral in the 1980s, there are other reasons to doubt the deficit is to blame for our low rate of national saving. The argument, made primarily by Keynesian economists, that the deficit is the key explanation for the decrease in private saving goes like this: American households are liquidity constrained, which in everyday language means they consume everything they can get their hands on. Hence, if the government takes less from them in the form of taxes they will consume today every dollar that would otherwise have gone to taxes.

There are a number of problems with the Keynesian argument, the most important of which is that essentially every study of liquidity constraints has demonstrated that at most 20 percent of American households are liquidity constrained; such liquidity-constrained households probably account for, at most, 10 percent of total U.S. consumption.

A second reason to doubt the Keynesian argument is that the growth of consumption expenditures has not been limited to nondurables and services, as one would expect if liquidity constrained households were the cause of the increased consumption spending. The share of total expenditures accounted for by durables is considerably higher in this decade than in the past three.

A third reason why the Keynesian argument doesn't square with the facts has to do with the composition of the reported deficit. If we take 1985 as an example, $130 billion of the $196 billion Federal deficit represents interest payments. The rest, $66 billion, is the excess of transfers over taxes. Since liquidity-constrained households obviously aren't bond holders, the key variable to consider for such households is the difference between taxes and transfers. And one should consider not simply this difference for the Federal government, but for all governments combined. For all (federal, state, and local) governments the 1985 difference between taxes and transfer payments is only $33 billion. While an additional $33 billion dollars in saving would have made some difference to U.S. saving in 1985, it would have increased U.S. saving, correctly measured, by less than one fifth of the 1985 saving shortfall arising from multiplying corrected net national product in 1985 by the difference in saving rates for the period 1950-1979 and for 1985.

Part of the explanation for the low private saving rate may be found in the U.S. demographic transition. In 1950 the fraction of the population over 65 was only 8 percent. The current figure is 12 percent. Over this period the fraction between ages 45 and 64 has been quite stable at roughly 20 percent. The final set of adults, those between ages 20 and 44, represented 38 percent of the population in 1950, but now constitute 40 percent of the population. What we see then is more young and old adults relative to middle age adults. But it is precisely young and old adults who tend to dissave on a life cycle basis in the U.S. economy; young adults tend to consume more than they earn, presumably in anticipation of higher earnings in the future. The elderly also dissave, or at least do not save significant amounts. Surprisingly, most of the life cycle saving for retirement appears to occur quite late in life among those age 45 to 64. Precisely how much of the saving decline can be explained by these demographics changes remains to be seen, but my conjecture is that demographics changes will explain only a fraction - certainly less than a fifth of the total shortfall in saving. Indeed, there are some reasons to believe that the demographic changes would be increasing saving by young American adults. Compared to the 1950s young Americans are having fewer children. One would expect young Americans to consume a fraction of the income that would otherwise have been spent on the upbringing of their children, but also to save a fraction; i.e., one would expect life cycle saving of young Americans to rise somewhat in response to their decision to have fewer children.

Another explanation for the decline in private saving may be the expansion of insurance which reduces the need for precautionary savings. The government today provides disability insurance, unemployment insurance, survivor insurance, earnings insurance (through the progressive tax structure), life span insurance (through its social security annuities), old age health insurance, nursing home insurance (through Medicaid) and poverty insurance (through its welfare programs). Economic research suggests that each of these forms of government insurance, while of great economic value, can have the undesired side effect of greatly reducing national savings. Untangling the savings effects of the provision of each of these forms of insurance is a formidable task, and one that is not likely to yield conclusive answers.

Another possible explanation for the decline in saving is a reduction in saving for bequests, which may tie in with the decline in the birth rate. At least half and possibly as much as two thirds of U.S. wealth can be traced not to life cycle saving for retirement, but rather to private bequests and other intergenerational transfers. It is hard to assess whether there has been a decline in the bequest motive for saving, but such a decline would not be surprising given the general deterioration of the family in the U.S. as evidenced by the dramatic post war rise in the fraction of marriages ending in divorce and the dramatic post war decline in the fraction of the elderly, even the infirm elderly, living with their children.

Much of the saving associated with bequests that occurred prior to 1970 may have reflected the absence of significant annuity insurance. Back in 1960 old age annuities were only a small component of retirement finances. Today, social security and private pension annuities are, more often than not, the major component of retirement finances. By annuitizing one's resources one eliminates the possibility of leaving such resources to the next generation. In other words, many of the bequests that occurred in the past may have been unintended, but with annuity instruments now widely available, there is less scope for unintentional bequests. The counterpart of smaller unintentional bequests and the availability of annuity insurance is that one can consume more since annuities have eliminated the concern about spending one's resources too quickly; i.e., the availability of annuities may have reduced significantly precautionary savings in response to life span uncertainty.

Yet another explanation of our low saving rate that might be advanced has to do with government saving disincentives. However, it is hard to argue that saving disincentives are responsible for the decline in savings in this decade since in the first half of this decade the Federal government reduced many saving disincentives. Some of the policies used to promote savings, such as the IRAs, were, unfortunately, poorly designed and probably reduced rather than increased saving. Others, such as the move toward a consumption-oriented tax base (associated with the adoption of the

Accelerated Cost Recovery System) were given too short a trial period; simulation studies indicate that many government policies aimed at stimulating savings can have significant effects, but need to be kept in place for decades, rather than a few years. Unfortunately, as a nation we seem to want to judge the effectiveness of policies within a year or so of their implementation, and such snap judgements may be highly inappropriate.

So far I have mentioned some of the possible causes and probable non-causes of our low national saving rate. There is little that is crystal clear in this puzzle; indeed, the only clear point is that a definitive explanation of the drop in U.S. saving in the 1980s will require significant additional research. What, in the meantime, can the Federal government do to restore our national saving rate to at least the level of the 1970s? One answer is simply to inform the public that this is a national problem which each of us needs to address at an individual level. The government could also help by requiring all employers as well as the Social Security System to send workers annual statements indicating their accrued retirement benefits plus a calculation showing the amount of additional private saving required to reach an adequate level of total saving.

A second step the government could take is to adopt a value added tax. Virtually all economists agree that a consumption-oriented tax structure would produce more saving than our income-oriented tax structure. In addition to not providing a saving disincentive, the redistributive effects of switching to a consumption-oriented tax base will also stimulate saving.

A third step is for the government to use the saving rate to target its fiscal policy. An increasing number of economists are questioning whether the reported deficit is a useful indicator of tight or loose fiscal policy. Under the guise of a balanced budget the federal government ran a very loose fiscal policy in the 1970s when it expanded the Social Security System. Other policies, such as The 1986 Tax Reform Act, while having little or no implications for the reported deficit, are also viewed by many economists as a loosening of fiscal policy. Running a tight fiscal policy involves placing a bigger fiscal burden on current generations. This can be achieved in a number of ways, some of which will affect the reported budget deficit and some of which will not. The tightening of fiscal policy should be gradual, but it should continue until the U.S. saving rate again reaches a level suitable to the world's premier economic power.

*Table 1*

*Net National Saving Rates and Household Saving Rates*

*Corrected and Uncorrected*

|  | Corrected Measures** |  |  | Uncorrected Measures* |  |  |
|---|---|---|---|---|---|---|
| Period | $(\hat{Y}-\hat{G}-\hat{C})/\hat{Y}$ | $(\hat{Y}-\hat{G}-\hat{C})/(\hat{Y}-\hat{G})$ | $\hat{G}/\hat{Y}$ | $(Y-C-G)/Y$ | $(Y-G-C)/(Y-G)$ | $G/Y$ |
| 1940-1949 | .086 | .101 | .271 | .055 | .059 | .274 |
| 1950-1959 | .133 | .167 | .203 | .092 | .116 | .211 |
| 1960-1969 | .130 | .166 | .215 | .089 | .116 | .226 |
| 1970-1979 | .118 | .152 | .223 | .085 | .109 | .222 |
| 1980-1985 | .072 | .093 | .230 | .050 | .064 | .223 |
| 1980-1987 | na | na | na | .044 | .057 | .225 |

na not available

* Y stands for the NIPA measure of net national product.
G stands for the NIPA measure of government consumption.
C stands for the NIPA measure of personal consumption.

** $\hat{Y}$ equals Y plus imputed rent on consumer durables and government tangible assets (excluding military equipment) less depreciation on the stock of consumer durables and government tangible assets (excluding military equipment).

$\hat{G}$ equals G less government expenditures on tangible assets (excluding military equipment), plus imputed rent on the government's stock of tangible assets (excluding military equipment).

$\hat{C}$ equals C less consumer expenditures on durables plus imputed rent on the stock of consumer durables.

Imputed rent on an asset is calculated as annual depreciation plus 3 percent times the stock of the asset. Annual depreciation of consumer durables and government tangible assets as well as the stocks of consumer durables and government tangible assets are reported in the U.S. Dept. of Commerce's _Fixed Reproducible Tangible Wealth in the United States, 1925-85_.

Chairman Rostenkowski. Dr. Makin.

## STATEMENT OF JOHN H. MAKIN, PH.D., DIRECTOR OF FISCAL POLICY STUDIES, AMERICAN ENTERPRISE INSTITUTE FOR PUBLIC POLICY RESEARCH

Mr. Makin. Thank you, Mr. Chairman.

I am pleased to be here to talk to the Ways and Means Committee about national saving. I would remind you that the chairman said to keep an open mind, that we are thinking about the long-run here, because today I am going to try to suggest to you that within the jurisdiction of this committee, the best thing that you could do to raise the national saving rate would be to insert a few "one-halves" into the Tax Code and tax only one-half of all interest income and allow deductibility to only one-half of all interest expense, including mortgage expenses on owner-occupied housing.

Now, I realize that that is a different approach to take and so my testimony will focus on why I suggest that approach, why I think it would probably increase the affordability of housing, and I even go so far as to calculate the impact on the after-tax monthly payments by a typical American with a mortgage of $100,000.

In other words, I think that this is an idea that has a lot of very positive benefits. It has understandable obstacles, one of them being the complexity. You may recall Treasury I attempted to move in this direction by indexing interest income and expense. There I think we did flounder on the shoals of complexity.

There is a simpler way to get approximately the same result and that is what I will call half-interest or HITAD, half-interest half-tax deductibility, so we will have a nice harmless acronym.

Secondly, there is the mortgage interest deductibility issue which is very sensitive. But I do think that given enough time, and if we had locks on the door, I could convince you that it would not be a bad idea politically. I understand the seriousness of that obstacle.

Now, first, how do I cut into this problem?

You look at our national saving rate, what we are worried about is we have to borrow so much money from abroad. Last year we borrowed $135 billion. Where did that problem come from? Two-thirds of it, about $90 billion, came from the fact the personal saving rate was off its normal pace by about $90 billion. A third came from the fact that the Federal budget deficit, instead of its usual 2 percent of GNP was 3 percent of GNP. So, yes, of course, you could try to raise the national saving rate by raising taxes or you could try to do something else unpopular and that is to encourage personal saving. That is what I am focusing on. I don't think there is any doubt in anybody's mind that when you are looking at American households, either encouraging more saving or forcing more saving is not going to be particularly popular. Americans like to spend money. That is why we are here wondering how we can get them to spend a little less money.

Now, how would we go about half interest?

Quite simply, all you would have to do, in terms of procedure, you just insert into the Tax Code whenever you are talking about an interest deduction "one-half." Whenever you are talking about interest earnings, you tax half of interest earnings.

The first effect, what would happen?

Well, first of all, if you change the Tax Code, borrowers and lenders are still going to be interested in the after tax real return. The table at the end of the testimony suggests, and shows what the new interest rate would be if you have left deductibility, so you have less encouragement to borrow, and you encourage savers to keep more of what they would earn if they saved more money.

Basically, an interest rate that today would be about 12 percent would drop to about 9.5 percent. The reason is quite simple.

We are trying to encourage saving so if you get more saving and less borrowing, the market interest rates will go down. You will still have a real after tax interest rate of about 2 percent.

Now, what about the notion that economists don't know much about whether you can encourage private saving with incentives?

I would argue that we really have not tried that way that we could expect to work. In 1981, we did try with the IRA accounts. The evidence was mixed, but on balance what we found was that people took accumulated assets in one form and put them into the IRA account which was a good way to reduce taxes, but it didn't increase, overall saving.

If you cut in half the tax take on interest earnings, then every additional dollar you save leaves you better off. There is no shifting asset strategy which leaves overall saving unaffected.

Now, you could get a panel of economists here who would argue all day about whether saving responds to higher interest rates. Along with my testimony, I have submitted what I confess is a very academic paper, but it investigates the responsiveness of personal saving in the United States to higher interest rates conditional on the pension funding formulae that both Larry and Barry have mentioned.

Basically, it tests the proposition that the way we calculate required pension contributions means that if you look at American data, you are going to underestimate the responsiveness of saving to interest rates. I certainly invite the scrutiny of that paper. It will appear in a very popular publication called the Review of Economics and Statutes, which sells maybe 50 copies, but we can make it available.

Now, I hate to talk about and bring up the deficit in this hearing, but I would argue, and I think I can argue convincingly, it would reduce the deficit if you went to half-interest. Two reasons. One, a lot of interest earnings that we now have is on pensions, accumulated pension assets.

Those are tax exempt anyway. So you are going to lose money on one side if you tax only half of interest earning, but if you allow half deductibility of all interest expenses, including owner-occupied housing, which is a tax expenditure currently of $35 billion, you will have a net revenue gain.

I invite the Joint Tax Committee and/or the Treasury to estimate how big it would be. I know it would be in the billions of dollars.

I don't have the wherewithal to make those estimates and if I made them and they weren't consistent with the more authoritative estimates, I would be wasting my time anyway.

But I invite this committee to suggest such a calculation to the Joint Tax Committee and/or the Treasury.

I promise I won't tell anybody that you are doing it.

Second, again, the proposal to make lending more attractive and borrowing less attractive is going to lower market interest rates. Now, the Congressional Budget Office estimates that a 1 percentage point drop in interest rates means a $75 billion saving in outlays on interest on the debt over 5 years.

We are talking here about a 2-percent drop, roughly, so you are talking about a potential outlay saving of $150 billion.

In other words, if deficit reduction is popular, or if you need cover on this kind of a proposal, I think it is very possible it could be designed in a way that you could point to considerable deficit reduction. Now, the last point briefly.

What is going to happen to a typical homeowner if you go to half interest? That is, if you say change the tax law and say you can only deduct half of your interest expense. First of all, you would probably want to phase it in over 5 years.

But what is going to happen to the typical homeowner is if he has an adjustable rate mortgage, since interest rates would be going down, his payments would be going down before tax and his after tax payments would—the fact he can only deduct half, would be tending to offset the fact he has got—lower interest rates would be tending to offset the fact he can only deduct half of the interest expense.

If he has a 30-year mortgage if you phase in over 5 years, you can renegotiate. If he is looking for a new mortgage, you are in great shape because you are basically going to get the lower interest payment.

I calculated in the table at the end that if you put half interest into place and you look at what is going to happen to interest rates, you would have for $100,000 mortgage about $25 a month increase in the after tax cost of the mortgage.

That is assuming that none of the other things we hope for would happen, that is the lower deficit. That is not assuming any effect of that on interest rates.

Finally, another positive effect here. Yesterday, we got the figures on housing starts. They were down very sharply reflecting a very typical pattern that when the Fed has to tighten up to fight inflation, the housing industry is hit very hard. One of the reasons is that as we get interest rates close to 12 percent, there is a sharp cliff over which we fall in terms of the number of households that can qualify for a mortgage based on their cash-flow.

With half interest you are going to have less oscillation of interest rates and a 12-percent rate is going to be below 10 percent.

You are going to have less cyclical impact of interest rates in the housing industry.

So I would close by saying I have tried this idea out on many skeptical people and I have even been able to convince a few people in the housing industry when you talk about the cyclical side of things that there might be something in this.

Thank you.

[The statement of Mr. Makin follows:]

## STATEMENT OF DR. JOHN H. MAKIN
## DIRECTOR OF FISCAL POLICY STUDIES
## AMERICAN ENTERPRISE INSTITUTE

### A Very Unpopular Argument for Higher Saving, More Affordable Housing and Lower Deficits

Mr. Chairman, I am pleased to offer some views to this distinguished committee on reasons for America's low national saving rate and measures to increase it.

Nearly every serious discussion of the American economy during the last few years has included a recommendation to raise the national saving rate. The best counter argument to the assertion that American budget deficits at about 3% of GNP are average for industrial countries is to observe that such a budget deficit would not be such a serious concern if America's saving rate were as high as that of other countries like Canada, Italy and Japan that have higher budget deficits as a share of GNP.

There are two ways to raise national saving rates. The government's saving rate could be raised if taxes are increased without an accompanying increase in government spending. Alternatively, the private saving rate could be increased by offering additional saving incentives or by removing existing saving disincentives.

In my testimony I shall argue in favor of removing saving disincentives currently in the tax code in order to provide larger incentives for additional saving especially by households. I believe that it is possible by such means to increase the personal saving rate back to its long-run average of 6.5 percent and thereby reduce America's external deficit by approximately $90 billion per year in 1989 dollars.

### Taxes versus Saving Incentives to Raise National Saving

I do not favor a tax increase as a means of increasing the national saving rate. I am skeptical of such an approach for two reasons. First, I do not believe that a tax increase would produce a dollar for dollar increase in national saving. This is particularly likely to be the case in the late 1980's because of the sharp cuts that have occurred in popular domestic programs since 1980. Domestic programs, (non-domestic discretionary programs) have fallen from 5.9 percent of GNP in 1981 to 3.7 percent of GNP in 1988 and 1991 and are projected to drop further to 3.3 of GNP in 1994. The fact that much of deficit reduction has been achieved through sharp cuts in popular domestic programs makes it highly likely that higher taxes would be used largely to finance restoration of such programs.

The second reason that I oppose higher taxes is that taxes have already been increased from a 1965-85 average of 18.5 percent of GNP to 19.6 of GNP in FY 90. Further, higher taxes introduce larger economic distortions. Estimates by John Shoven and others suggest that such distortions cost the economy about $1.30 for every additional dollar of revenue.

I am well aware that by proposing additional incentives for private saving I am entering controversial territory. The conventional wisdom about saving is that no one knows what makes it go up or down much less what tax policies would encourage it or discourage it.

Undaunted by these discouraging propositions I would like to offer three simple arguments for removing saving disincentives that are now in the tax code. First, people will save more if they are encouraged to save with an incentive that operates on every dollar of additional saving rather than an incentive like an IRA plan that allows individuals to take advantage of the tax saving offered simply by reallocating existing savings.

Second, I would argue that the United States has really never tried to increase aggregate savings with tax incentives or removal of tax disincentives. And finally, an attempt to encourage saving by enhancing after-tax returns to saving and increasing the after-tax cost of borrowing carries with it many attractive side benefits including deficit reduction, more affordable housing and a lower external deficit all of which deserve serious consideration.

I have tried to address one of the key issues surrounding tax incentives for saving in a research paper attached to my testimony. Essentially the paper examines the proposition that the way pension funding formulae are specified in the United States, imparts a downward bias to the measured responsiveness of saving to interest rates. Results obtained are supportive of the proposition that personal saving does respond positively to higher after-tax returns and are offered here as additional reason to consider attempting to induce more private saving by altering the tax treatment of income interest and expense.

## Correcting the Tax Code for Anti-Saving Bias

It has long been recognized that the tax code distorts the tax treatment of interest income and expense in a way that saving is discouraged and over-borrowing is encouraged. These distortions rise with the inflation rate.

A proposal to correct the tax treatment of interest income and expense was included in the November 1984 Treasury Tax Reform Plan. The proposal was unnecessarily complex. A much simpler approach, call it "half interest tax and deduction" or HITAD would help to correct the over-borrowing under-saving bias in the tax code by taxing one-half of interest income and allowing deduction of only one-half of all interest expense. The correction is very simple to apply, requiring only the insertion of "one-half" into a few lines of the tax code.

HITAD would raise the private saving rate, especially the currently low personal saving done by individuals. Individuals would get to keep more of the interest earned on every dollar of saving and so would save more. This incentive is superior to the IRA plan which induced savers simply to move already accumulated savings into IRA accounts. They saved on taxes but didn't increase overall saving. HITAD would reward every addition to saving with more after-tax interest.

HITAD would also discourage over-borrowing. Borrowing for everything from leveraged buyouts to speculative purchases of real estate would be discouraged at current interest rates with only half of the interest expense deductible. The $2 billion plus annual interest bill on the approximately $20 million of junk bond financing for the RJR Nabisco leveraged buyout, currently reduced by about $680 million a year, thanks to full interest deductibility and a 34 percent corporate tax rate, would be reduced by $340 million under HITAD. Taxes paid to the Treasury would rise by $340 million.

After HITAD was fully phased in the after-tax real cost of borrowing would be unaffected because more saving (lending) and less borrowing would mean lower market interest rates. With lenders and borrowers still agreed on an after-tax real interest rate of about 2 percent, a 12 percent pretax market rate under current tax law would drop to about 9.6 percent. (See Table 1)

## Other Benefits of HITAD

America's trade deficit and foreign borrowing requirement would be cut by the HITAD proposal. About two-thirds of 1988's $135 billion in foreign borrowing as measured by our current account deficit results from an abnormally low personal saving rate and about one-third results from our budget deficit that is about $45 billion above its usual level of 2% of GNP. If the personal saving rate were raised to 6-1/2% of disposal income, its normal long-run level, the external borrowing of the United States would fall from $135 billion a year to just $45 billion per year. We would be on the road away from our current "Global Debtor" status.

HITAD would help cut the budget deficit in two ways thereby reducing even further our need to borrow from abroad. The revenue loss from not taxing half of interest income would be less than the revenue gained from eliminating half of interest deductions. The reason follows from the fact that much of interest earning now accrues to pension funds that are already tax exempt while the interest expense deduction is heavily used as any follower of leveraged buyouts or high priced real estate knows. Capping the interest expense deduction at just half its current level would gain billions more in revenue than would be lost by taxing only half of interest income.

The second revenue gain from HITAD would come from the lower interest rates that it would induce and the resulting interest saving on the national debt. The Congressional Budget Office estimates that a 1 percentage point drop in interest rates produces a saving on interest outlays of $75 billion over five years. As is clear from Table 1, for inflation rates in the 4-6 percent range a reduction in market interest rates of 1-1/2 to 2% could be anticipated under HITAD. The result would be outlay savings over five years in the $100-$150 billion range.

## HITAD DOES NOT PENALIZE HOME OWNERSHIP

One of the primary political impediments to the passage of HITAD is a feared vicious voter backlash since it would scare everyone with heavy mortgage payments. It needn't. The HITAD provision on mortgage payments could be phased in gradually over five years. As it becomes phased in interest rates would fall and existing homeowners with adjustable rate mortgage would benefit automatically while those with fixed rate mortgages could finance at lower rates.

HITAD would be especially helpful to first-time home buyers especially those who either are in lower tax brackets or do not itemize deductions. Lower interest rates and the slower rising home prices that would result from less demand for housing purely as a tax shelter would both contribute to more affordable housing.

This is just another way of saying that the use of the tax code to turn home ownership into a tax shelter pushes up the demand for housing and helps those who already own homes at the expense of those who do not. Since the value of homes and the rate of home ownership both rise with wealth, the tax breaks for housing that are usually portrayed as helpful to average Americans actually help the wealthy at the expense of those in the lower-middle income categories.

Lower interest rates would also help to avoid disruption in the housing market that now occurs when mortgage rates rise over

12 percent. At about that level there is a sharp drop in the number of households with cash flow sufficient to qualify for a mortgage on an average priced home. Home sales dry up. HITAD, by lowering to about 9.6 percent interest rates that under current tax law would average 12 percent would enable more people to qualify for mortgages during periods of tight money.

The fact is that HITAD would have relatively little impact on the after-tax cost of mortgages. Table 1 shows an array of interest rates under current law and under HITAD that would prevail for inflation rates ranging from 3 to 8 percent. Column 3 in Table 1 shows the reduction in monthly and annual mortgage costs under HITAD. At a 6 percent inflation rate with a drop of the market interest rate from 12 to 9.6 percent the annual reduction in outlays for a $100,000 mortgage would be $2,124. On an after-tax basis monthly interest payments for a $100,000 mortgage with a 6 percent inflation rate would rise only $21 assuming that none of the other beneficial effects of HITAD on savings rates and deficits would have any additional effect in pushing interest rates down.

HITAD leaves unaffected many existing preferences for owner-occupied housing including deferral of capital gains on principal residence, a one-time $125,000 exclusion from capital gains tax and the full deductibility of state and local taxes on owner-occupied residences.

## Other Issues

Some observers have argued that restricting interest deductibility would place domestic investors at a disadvantage relative to foreign investors who have full interest deductibility. All else equal, this argument is true. But HITAD would reduce our external deficit and increase national saving thereby helping to strengthen the dollar. The primary reason for aggressive foreign buying of U.S. assets today is a very weak dollar. By encouraging domestic saving, it is by definition true that less capital inflows are required to finance our own investment. Other things equal, HITAD would strengthen the dollar and reduce foreign buying of U.S. property.

Beyond the benefits already mentioned, HITAD coupled with an end to the double taxation of dividends would go far toward quelling the wave of leveraged buyouts. Such leveraged buyouts are arranged primarily for the benefits of a very quick transformation of corporate balance sheets from equity to debt-liabilities. The instant tax-induced improvement in cash flow enhances the value of the property being bought out and encourages substitution of debt for equity.

## Conclusion

If, as a nation we are serious about encouraging less spending and more saving and achieving all the desirable effects that go along with those changes, surely removing saving disincentives in the tax code should be high on the list among our policy proposals. Surely this alternative is preferable to seeking additional revenue through higher tax rates that, without HITAD would result in still higher interest rates and still more demand for housing as a tax shelter. First-time home buyers and lower income Americans would be further squeezed by such developments.

Finally, a measure that would encourage saving by helping to reduce the budget deficit would have a double impact in increasing national saving. I invite the scrutiny of Ways and Means Committee Members and Staff of our study on Saving Behavior and Its Responsiveness to Interest Rates and would welcome estimation by the Joint Tax Committee and/or the Treasury Department of the impact of HITAD on the budget deficit.

### TABLE 1

### Inflation Interest Rates and Mortgage Costs

| Inflation Rate | Current Law Effective Marginal Rate - 0.333[1] (interest rate in percent) | "Half Interest" Effective Marginal Rate = 0.167[1] (interest rate in percent ) | Reduction on Monthly/Annual Mortgage Cost with "Half Interest" [2] (Dollars per $100,000 mortgage) | Rise in After-Tax Monthly interest Payments under "Half Interest"[2] (Dollars per $100,000 mortgage) |
|---|---|---|---|---|
| 3 | 7.5 | 6.0 | 98/1176 | 33 |
| 4 | 9.0 | 7.2 | 124/1488 | 29 |
| 5 | 10.5 | 8.4 | 150/1804 | 25 |
| 6 | 12.0 | 9.6 | 177/2124 | 21 |
| 7 | 13.5 | 10.8 | 204/2448 | 17 |
| 8 | 15.0 | 12.0 | 231/2772 | 15 |

---

1. After-tax real interest rate set at 2 percent

2. Mortgage term set at 30 years

Chairman **Rostenkowski**. Thank you, Dr. Makin.

I preface my question with the assertion that we have no specific legislation before us. But I would like, however, to ask you if you could enact one policy, one policy to boost savings, what would that be? I would like an answer from each of you.

Larry.

Mr. **Kotlikoff**. Well, I would enact a value added tax and probably do that on a balanced budget, in a balanced budget manner since there is so much concern about revenue neutrality.

But I think that would place a larger burden for paying for the Government's consumption on current generations. To be perfectly honest, it would place an even larger burden on older generations than on younger generations.

Economists think there are two reasons that people adjust their consumption. One is an incentive reason and John was referring to that when he talked about interest rates and taxes on interest.

The other is kind of an income effect. If you reduce people's resources, if you reduce their budget, what they can spend over the rest of their life on consumption, then they are going to consume less. A consumption tax has the implication that it affects adversely the resource position of middle age and older Americans and the impact of that is positive for national saving because older Americans have higher marginal propensities to consume than do younger Americans and clearly larger than those Americans who aren't yet born.

So when you switch to a consumption tax from an income tax structure, which is what we currently have, you really shift the tax burden on to older generations and away from future generations.

We are worried in large part about these deficits because of their intergenerational implications the fact we think we are putting a bigger burden onto the future generations, and we are letting current generations off the hook and letting them consume a lot more today.

Shifting the tax structure in this manner would put the burden back onto current generations, especially onto older generations. I think that would increase our national saving.

Chairman **Rostenkowski**. Barry.

Mr. **Bosworth**. My preferences would be in the area of trying to expand private retirement savings. As I mentioned in my testimony, almost all household savings today is in the form of pension fund accumulations. But private pension funds have ceased to expand in covering a larger proportion of the American work force.

Only about 50 percent of American workers have a private pension and that percentage has not increased since the mid-1960's.

I think we wish people would provide more for their own retirement, particularly in low income groups and particularly with small businesses.

So I think we have a social reason that we would like to encourage retirement saving, and I think pension funds, because of their contractual nature you can't get your hands on the money, are a lot more effective than various tax incentives.

I am much more skeptical that tax incentives, while they have a tremendous impact on the allocation of savings will have much effect on the total amount of saving that each one of us will do.

I think this committee, although its jurisdiction is taxes, runs the risk of thinking that taxes is all that matters.

Chairman ROSTENKOWSKI. John.

Mr. MAKIN. Taxes aren't all that matters. But I think we can get agreement on that. I just respectfully disagree with Barry on the potential effect of this. The one thing I would do would be to try half interest, try an incentive because of the many favorable side effects.

This committee among them, this committee has heard a great deal of testimony on leveraged buyouts. I don't think it is any mystery that the primary reason for leveraged buyouts is to take the liability side of a company's balance sheet and switch equity for debt.

The reason is that after tax cash-flow pops up nicely. In my testimony, I indicate that the Government would collect $340 million extra on the RJR in a business company takeover under half interest. Might not have even happened at half interest. So I think we should try to think about something that lowers interest rates, encourages private saving, lowers the deficit, before we go to major surgery like a consumption tax.

I testified to this committee in favor of a consumption tax in the past. Over the years, I think two things have become clear to me. One, to do a consumption tax right is a major bit of surgery on the Tax Code. I do not think the Tax Code can stand major surgery right now.

Second, that means that things that we might think about doing should be simple and precise. That is why I think of the half interest.

Chairman ROSTENKOWSKI. Thank you.

Mr. Archer.

Mr. ARCHER. Thank you, Mr. Chairman.

Gentlemen, this may sound rather simplistic, but what is the purpose of savings?

Mr. MAKIN. Savings is to provide for an increase in future consumption, to provide for a rainy day, to put it in popular parlance. One of the reasons I think that Americans do relatively little of it is quite simply that they are more optimistic than others about the future.

This is a country in which something has always turned up to provide for increases in future consumption without being like little squirrels and putting nuts into trees.

Mr. ARCHER. Why is future consumption more important than current consumption?

Mr. MAKIN. It is not.

Mr. ARCHER. So why have savings if that is the only reason for savings?

Mr. MAKIN. The reason that is normally given is that you have got to have saving in order to put aside something from current consumption to invest in capital and to provide for more income in the future.

But if you don't——

Mr. ARCHER. So all of you agree the purpose of saving is to have capital to invest?

Mr. MAKIN. Which in turn——

Mr. **Bosworth**. Sounds good to me.

Mr. **Archer**. All right. I want to get to this point. If that is the purpose, then isn't it just as important to protect the current pool of capital savings from erosion as it is to talk about how we can increase savings so that we can have more capital to invest?

Not a one of you mentioned that in your testimony.

Mr. **Makin**. It is important to distinguish between saving and investment. Saving provides the means for investment but as we see, the money flows where the opportunities are. Although we have a low saving rate here, a lot of capital flows here from abroad because——

Mr. **Archer**. I understand that. Most Americans have some concern about the dependency upon foreign capital. My assumption is that the purpose of savings is to develop our own domestic pool of capital, and all of you agree to that.

But not a one of you talked about how we preserve the current pool of capital that exists domestically in this country. You only talk about what do we do to try to expand upon that.

Is it not just as important that we preserve the current pool, that it not be siphoned off, say, in the form of capital gains taxes?

Mr. **Makin**. I think here again——

Mr. **Archer**. Is it not true capital gains taxes primarily come from capital and not from consumption?

Mr. **Makin**. I think you have got to—if you are not adding to the pool of capital, it is going to get smaller. Capital gains, I think, again, I would have the same type of suggestion, index capital gains for inflation.

Mr. **Archer**. Wait a minute. If you are not adding to capital, the capital pool gets smaller. That is an interesting statement. If you are not touching the capital pool, the fact that you are not adding to it is not going to make it smaller, is it?

Mr. **Makin**. I attempted to use this glass of water and this cup here. If the cup is half full, that is the stock of capital. If now we encourage more saving and the saving flows into investment, the capital stock will get bigger.

Mr. **Archer**. But is it not true that when we tax capital gains, which most of our foreign competitor countries do not do, that we are reducing the glass that contains our capital savings?

If that cup is half full of capital savings and we have a capital gains tax that every time you transfer this capital, the Government is reaching in and siphoning out part of what is in that half-full glass, don't we increase our job for other savings incentives just to get back to half full before we can build that up?

Mr. **Makin**. You know, I don't think we disagree on this.

Mr. **Archer**. But you seem to be arguing with me.

Mr. **Makin**. No, no. I think what you want to be sure of is that you have adequate incentives to add to capital. I could say——

Mr. **Archer**. Wait a minute.

I am talking about retaining what we already have before we can add anything to it.

Mr. **Makin**. With capital gains you are worried about somebody being locked in because they have a big gain and they are going to be taxed heavily on it and that is why I think it would be wise to tax half.

Mr. **Archer**. You miss the point. What I am concerned about is when you sell a capital asset, which represents capital savings and is part of the nucleus and pool of capital in this country today, the Government is going to take a third of the gain. If you have held it for any period of time, the tax can be a significant part of the total purchase price or sale price. The tax is going to take a third of it, which removes it almost dollar-for-dollar away from your pool of capital.

Mr. **Kotlikoff**. Let me respond.

I think I see your question. When the Government takes away capital gains receipts, it brings it into the Treasury and then it pays it out. What we are trying to say is what you really want to focus on is out of the total output of the economy, how much is being consumed. The fact the Government takes some receipts from this party, brings them into the Treasury and then pays them out does not necessarily in itself change consumption because the people that it takes the funds from——

Mr. **Archer**. I understand what you are saying. We are talking now about the net result of savings. All three of you nodded in agreement that the net result of savings is capital formulation establishing a pool of domestic capital.

Mr. **Makin**. I have to cut my "nod" in half because the savings could flow out. All the saving in Japan does not establish capital in Japan. It establishes capital that Japanese own around the world. We could do the same thing if we had higher saving.

Mr. **Archer**. The whole thesis of this exercise today is to talk about savings in this country compared to savings overseas. Now you are trying to cloud the issue by saying you can't distinguish between the two.

Maybe we shouldn't have this exercise today. If you can't distinguish between the two and it does not matter, we should not have this exercise.

Mr. **Kotlikoff**. Let me say the way economists view capital formation is just the difference between output and consumption. So your question about capital gains taxation has to ultimately go back to the question of will having a capital gains tax mean more consumption or less consumption for the country and through that channel, affects capital accumulation. Now, it is true that how much wealth we accumulate, which correspond to our saving, is different from how much investment occurs in the United States because we can put some of our saving abroad.

But the most important thing for the United States is not only how much investment occurs within the United States but also how much wealth U.S. citizens have.

Even if they have some of their wealth abroad if we don't have that wealth abroad in 20 years we, if we have less wealth than would otherwise be the case we are going to be the poor country on the block.

We may not be poor because we have got less plant and equipment in the United States, we will be poor because we don't own the plant and equipment in the United States because the Japanese or the Europeans own it. So there is a concern about wealth accumulation, which is separate from a concern about how much investment is actually occurring in the United States.

Mr. ARCHER. Well, wealth accumulation, I would submit to you gentlemen, even if you assume it is worldwide, is subject to the capital gains tax every time there is a transfer of a capital asset and that is a reduction of the wealth accumulation of the people of this country.

It is going in to the Public Treasury, and although you may agree some of the public spending is for capital items, the majority of it is for consumption items. I don't think you would argue with that. But also I would argue with your concept of what is capital and what is not capital.

If you think a refrigerator is a capital asset for this country, then the shoes that I have on are a capital asset because they are over 10 years old.

Chairman ROSTENKOWSKI. Mr. Coyne.

Mr. ARCHER. Thank you, Mr. Chairman.

Mr. COYNE. Thank you, Mr. Chairman.

Would the panelists comment on what effect the Government's intervention in fields such as retirement, catastrophic health events, and education have on the perceived need for Americans to save?

Mr. KOTLIKOFF. I conducted several different studies myself, more in the simulation mode, which is to say you set up a hypothetical economy and ask if the Government provides this kind of insurance, like disability insurance or insurance for sickness in old age, how will they affect the amount of precautionary savings.

Indeed, you can find very substantial effects. That certainly is one of the potential smoking pistols in this whole story—that we have less precautionary savings because of the U.S. Government's provision of insurance of different types.

The insurance provision, per se, is very good. That it has had this unintended side effect, I think, of greatly diminishing our saving.

Mr. COYNE. Thank you.

Chairman ROSTENKOWSKI. Mr. Moody.

Mr. MOODY. Just following up on that, if that is self-funded programs, as catastrophic is, does the savings rate necessarily drop as we pull that money out of consumers' pockets to finance that catastrophic health care?

Mr. KOTLIKOFF. If the programs are self-financing, what that comes down to is you are not putting the burden onto the next generation. You are not having those kinds of income effects on different generations, thereby affecting their consumption.

So you are not doing that.

But just the provision of insurance, per se, makes people's lives less risky.

Mr. MOODY. If you have risk pooling, you reduce the variances.

By the way, Mr. Chairman, I am delighted to welcome my former colleague from the Economics Department at the University of Wisconsin.

John, welcome.

What do you draw from the Canadian experience? I think they treat mortgage interest differently. They have a much higher interest rate. I am not suggesting those are related.

Have you looked at the different tax treatment in Canada, or Government programs in Canada, particularly on the tax side, as explaining their much higher savings rate?

Mr. MAKIN. There has been some investigation. I have actually been a guinea pig. I lived in Canada for a while. There have been changes in tax policy there. Of course, the deductibility of mortgage interest—it is not at all deductible. The Canadians have, I believe, or have had a plan where you can earn up to $3,000 or $4,000 in interest and not have it taxed at all as opposed to simply allowing half interest.

There have been a number of studies on this as a possible explanation of their saving rate. I can't say that the results have been decisive and conclusive. They are only suggestive there may be something there having to do with tax treatment of interest income and expense.

Mr. MOODY. Of course, it might be useful to study it. The Canadian culture is so much more similar to ours than the Europeans.

Mr. MAKIN. Recently the Canadians took away the favorable treatment of interest income.

Mr. MOODY. Do the Canadians put less money than we do in housing? There is an assumption we are overhoused.

Do Canadians use less of their investment in housing?

Mr. BOSWORTH. No, they don't. That is one of the surprising things that the share of national income in Canada going into housing appears to be extremely similar to that of the United States and there are some explanations for it.

The Canadians have a somewhat faster rate of growth of the young population in the home-buying age. Home ownership rates in Canada are within a couple of percentage points of where they are in the United States.

I did do one study recently——

Mr. MOODY. Excuse me. Then the huge tax expenditure—if I can use that term—of home ownership in America may not be getting much for the dollar?

Mr. BOSWORTH. Part of that is true, but there is a different distribution of income in Canada than in the United States. There is a different demographic structure than there is in the United States. One of the big effects of the Canadian mortgage interest provision appears to be it really exposes homeowners to mortgage interest rate fluctuations. Canada has essentially a variable or adjustable rate mortgage plan.

Therefore, there is a lot more precautionary saving when interest rates start going up. Canadian saving rates are more sensitive to monetary policy.

Mr. MOODY. The Government isn't sharing some percentage?

Mr. BOSWORTH. The Government is not splitting the risk.

Mr. MOODY. Larry.

Mr. KOTLIKOFF. I think it would be incorrect to say the Canadians aren't subsidizing housing in the way we are. I think they are. They don't allow interest deduction on mortgages, but if you own your house outright, you are still getting implicitly a housing subsidy because you don't have to pay taxes on the imputed rent. You are in effect, getting tax-free rental income from living in your house.

So in Canada, to a greater extent than in the United States, the financing of housing is done on an equity basis rather than a debt basis. There is still in terms of the fundamentals a tax subsidy, too, a tax break, too, on housing in Canada.

Mr. MOODY. Let me shift the questions for a moment and talk to Barry about the dependence on foreign capital inflows. If people are willing to send us capital goods, while we send them pieces of paper with George Washington's picture on them, what is so bad about that? You mentioned if we sealed our borders, interest rates would skyrocket. Since we are not going to seal our borders, is this an open-ended positive gain at the day of reckoning?

Are there a series of events which have caused capital inflows to suddenly stop or reverse, throwing our economy into a tailspin?

Do you see a scenario there?

Mr. BOSWORTH. I think there are some economists, particularly earlier in this decade, that argued that there was a big risk of interruption of that capital flow. However, I don't see anything in the behavior of economic markets that will stop the process until the United States runs out of assets to sell to foreigners.

Americans aren't exactly getting a big favor from foreigners. We have the highest real interest rates at any time in this century. The Japanese are being rewarded extremely handsomely by the United States to loan us the money.

Americans pay a high interest rate to finance that capital flow and future generations are going to see an ever-rising magnitude of the interest payment burden that they are going to have to make to finance the consumption that we did today.

So I don't exactly see this as free.

Mr. MOODY. If we keep borrowing the interest?

Mr. BOSWORTH. You run out of assets after awhile.

Mr. MOODY. John.

Mr. MAKIN. I guess I am not really that alarmed. You have to remember we have assets abroad, we have assets here. At market value, they are probably about equal. It is true a few years ago the value of our market assets abroad exceeded the value of our assets here. Frankly, as I look at interest rates right now, I believe the long Treasury bond is at 8.9 percent today with anticipated inflation at 5 percent and taxes, the extra tax real rate is about 2.5 percent, which is not atypically high.

I think one of the reasons, frankly, for the low personal saving rate in the United States, the low national saving rate in the United States during the eighties has been the fairly attractive terms on which foreign investors are willing to lend to the United States, and that is in part related to the relaxation of controls on capital outflows from countries like England and Japan.

So we have been the beneficiary of the desire to diversify portfolios abroad. We would not want to overdo our spending in response to that, but I think it is important to point out today that the personal saving rate, while it is low, in 1988 at 4.2 percent of disposable income, it is up from 3.2 percent in 1987 and the numbers for the first 2 months of 1989 are back in the 6 to 7 percent rate.

It looks to me like we are beginning to pull back our horns and adjust the personal saving rate up a bit.

Mr. MOODY. Thank you.

Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Frenzel.

Mr. **Frenzel**. Thank you, Mr. Chairman.

Dr. Bosworth, I thought your presentation was wonderful. I am glad there is somebody else around here besides me, namely, you, that doesn't understand the problem, and believes we have to begin by reducing the deficit.

I would like to ask the whole panel this question. There is, particularly among what you might call the bucket shop economists, the theory that personal savings are beginning to increase because our boomers are aging and moving into a different status in life, in which savings become more important. Therefore, this trend is going to become more pronounced.

Do we look there for any consolation?

Mr. **Bosworth**. I would just say that the demographics should go in the direction of raising the private savings rate over the next couple of decades. My note of caution is I would like to see the economic studies be able to explain past rates of savings. All of a sudden demographic explanations have become very popular, but the historical evidence is weak.

The basic problem, as pointed out by the current Chairman of the Council of Economic Advisers, is that from 1960 to 1980, the portion of family income earned by people in the age bracket of 45 to 65 steadily went up. Those are the high savers.

The baby boomers were children by definition earning no income but responsible for a considerable amount of consumption. All of that should have lead you to expect the private saving rate to decline in the fifties, the sixties, and the earlier seventies. Instead it just stayed constant. All of a sudden, in 1980, the demographics do turn around. The baby boomers are moving into the brackets where the savings rate should be going up. Suddenly, the private savings rate drops.

Maybe it is true that in the future these demographics will come out to predominate. There has not been strong empirical evidence, however, that demographics is a powerful influence on saving either here, in the United States, or in other countries.

Mr. **Frenzel**. Thank you.

Mr. **Kotlikoff**. I would disagree a little bit there. I think the data shows that the proportion of older adult Americans and younger adult Americans is higher in this decade than it was in the fifties, sixties, and seventies. For example, the fraction of the population over 65 in this decade is 12 percent. It was 8 percent in 1950. Now what you have is an increase in the shares of the population in precisely those age groups where there is relative dissaving compared to the middle ages of 45 to 65. So I agree with Barry that economic research hasn't shown a very strong effect of demographics yet, but I think there is something in the demographic story to explain why the saving rate is low now.

I also would expect to see some upturn in the saving rate due to the demographics in the next two decades, followed by a rather substantial decline in the saving rate when we have this big baby boom generation more into their old age.

Mr. **Makin**. I would argue that Mike Boskin's work leads me to be optimistic about the saving rate. This is part and parcel in agreement with Larry. The baby boomers now, I believe, are 24 to 44. They are just aging into their peak saving years.

Mike's work suggests that that there may be a lower overall life cycle pattern of saving among individuals born after or postwar individuals as opposed to pre-war individuals, but there is evidence of a life cycle pattern and as the very numerous baby boomers now age 44, age another 5 years, I would expect to see higher personal saving by them.

Mr. **Frenzel**. Thank you.

John, regarding your half-and-half system, I think it was in Hamlet where Pelonius advised his one Laertes to be neither a borrower nor a lender. Neither was a small businessman. How do we get businesses started and growing if we don't allow people to deduct the cost of the use of money?

Mr. **Makin**. Here again by having lower interest rates. The small—the people who benefit most from the current law, the small business would have an effective marginal rate of 15 percent on the first 75,000. So the relative beneficiaries of the current law are the big businesses that can deduct at 34 percent.

So we have lower interest rates, enabling gain relative to their competitors that are larger and stronger. So I see no real problem there.

Mr. **Frenzel**. Thank you very much.

Chairman **Rostenkowski**. Mr. Thomas.

Mr. **Thomas**. Thank you, Mr. Chairman.

I was looking at the acronym you established, HITAD. I think it could stand for house incumbents turn advantage to defeat if they go out and try to advocate it. You indicate if you had locked doors, you might be able to sell it.

A lot of us would like to advocate locked doors when we try to explain positions. Unfortunately, we don't have the time. I think your approach may have merit, but there is not enough time on the clock for most of us to explain it.

I have real difficulty believing the demographic trend agreements given the different worlds in which you try to compare those demographic shifts. I have a difficult time thinking we are ever going to recreate the mental set of the fifties which was the onset of the welfare state with a personal mental set of the survival of the fittest.

That combination, I think, produced those high savings rates. I just have no belief that youngsters believe they have to worry about tomorrow and I know you can take the data as you have to a certain extent and indicate that there is a possibility that the saving rates will change, but I have such a low level of confidence in that that I have to look to other areas.

I really enjoyed all of you. I don't expect economists to agree. They are not supposed to. You have upheld your discipline's approach to explanations.

My concern is about the fact that you have me feeling rather helpless as a member of this committee in terms of any meaningful alternatives we can put forward in the next several years. What about the general approach given the impact of government in today's economy, more so than in the past?

Obviously a balanced budget helps. Is there a way to it that helps more than other ways?

Let me ask that as a general question. I am not encouraged that we are going to move in that direction. If we did, what would be the procedure?

Mr. MAKIN. Congressman, let me try to answer that question with a suggestion on how to deal with your constituents.

Ask them a question: Would you pay $20 more per month for your mortgage in exchange for a $60 billion cut in the deficit?

Mr. THOMAS. The answer, if it is my mortgage and their deficit, no. You are asking them to elevate their personal concerns to the national and international level. They have shown time and again they are not willing to do that. They will give verbiage to it.

They will not give dollars to it.

Mr. MAKIN. Then you will continue to have a large deficit.

Mr. THOMAS. I understand that. That is your response in terms of the question?

Mr. MAKIN. I think you can make a case. You can say what can we do that is constructive to deal with the problem? If we have concern about a national saving rate and our overall deficit, I think that you got—first of all, people won't accept, they can't be better off by saving more today. You probably won't be able to do anything. But I think this is probably the best you can do.

Mr. THOMAS. I don't think you can convince people they wouldn't be better off if they saved more, but I think they would want to see a direct personal advantage to the saving, that is; the IRA's in which they clearly pocketed money, even if it was moved from one place to the other.

When they did their income taxes, they saw a personal benefit. They then understood the value of savings.

Mr. KOTLIKOFF. I was advocating the idea of sending annual Social Security reports to U.S. citizens that would indicate how much in addition they need to save to be able to maintain in their current standard of living. I think if we sent such reports, that would really drive home this concern about national saving rate, and the message that the Government is not going to bail everyone out at the end of the day.

I think that that is a cheap step that could be taken. It would really change the atmosphere about saving and get the young people conscious of the problem.

Mr. THOMAS. My concern to that would credit an ever-increasing membership in the AARP and a greater lobby in the United States.

I think it is not really a solution. It is simply an invitation for having the lobby doing more.

Mr. KOTLIKOFF. That, brings me to the issue of the deficits. I think that by looking at these deficits, we have been missing the economic forest for the trees for several decades now. If you think about the 1970's, we had this big expansion on the unfunded Social Security system which was a huge intergenerational transfer. It never showed up in the reported deficit.

Had we labeled our receipts differently, had we called Social Security taxes a loan from the private sector to the Government and the payment of benefits, had we called the benefits, repayment of principal plus interest on those loans, we would have had an entirely different reported official deficit. We would have seen deficits on the order of $400 billion in the 1970's.

So I think we are looking at a set of numbers which are not telling us the true generational story. One thing Congress could do is to measure in generational terms the present value of what we are taking from older generations, younger generations, and what we expect to take from the next generation?

The sum of these numbers will add up to the present value of what the Government is consuming. If we had a description like that, it would be very clear to the AARP and everybody else, that if you give more to one generation, you will have taken it from another generation.

Mr. THOMAS. That is useful. I tried to advocate that we take a look at demands on current services and see what age block receives those benefits and what responsibilities have been carried over to yet unborn.

If you are going to break down Government's goods and services that way, I think you then begin to understand there are groups in this country who are getting far more than their fair share.

Thank you very much. I enjoyed the panel a lot.

Chairman ROSTENKOWSKI. Mr. Dorgan.

Mr. DORGAN. The panel's presentation was very interesting. We appreciate that.

Let me just ask a question directed to the three of you and preface it with a short description of what I am talking about. You are talking about public policy initiatives to promote savings. I think that is a good thing for us to discuss.

In the private sector, you can't go downtown from this building this afternoon without seeing a sign in a picture window that says to a consumer that drives past or walks past "come over here a second", the picture window says with big red letters. "We want you to buy what is in our window. It doesn't matter if you can't afford it. We will give you the product. We will send you home with the product. You don't make the first payment for 6 months. Next month you get a rebate."

The things we are getting in the mailboxes, unsolicited credit cards, they are being sent to us. I have a fairly large stack: platinum, gold, preferred, all sorts of gimmickry credit cards.

My daughter is a student with no job. She just got an unsolicited credit card from two different sources.

The question is—and incidentally, in the last 2 weeks, my wife has gotten in the mail two separate solicitations saying she has been preapproved for $2,500 loans. You are probably familiar with those.

All she has to do is sign the line. She has a preapproved $2,500 loan.

The question is with a blizzard of incentives in the private sector that say, don't defer consumption, spend money you don't have immediately and put it on the 18-percent charge card, or we will get you a rebate quickly, what would you recommend we do in the public policy to deal with that kind of incentive that seems to drive the private sector behavior?

**Mr. Makin.** It sounds like a lot of mailings were initiated before the outcome of the pay increases was decided, hoping you would have more disposable income.

Let me move along.

**Mr. Dorgan.** We don't appreciate references to the pay increase here.

**Mr. Makin.** I am sorry. I apologize.

You know, I don't think there is any way you are going to stop the siren call of current consumption from being present. I think what you basically have to do is sort of the—what I call the three little pigs approach. That is the individual or household that puts aside more for the future has to be rewarded.

Again, that is why I think of making it less attractive to borrow and more attractive to save. I don't think there is any way to do it.

It won't be popular, because you will be going against——

**Mr. Dorgan.** I understand that point. My point is we provide some incentives to save, and you still have this blizzard in the private sector saying don't save for God's sake, spend. You don't have to have it to spend it.

**Mr. Kotlikoff.** It is important for the Federal Government to take a role in sending out some mail of its own. I talk to my undergraduates. I ask them what happened in 1983 to their Social Security benefits? Nobody knows. When I tell them they lost 15 to 20 percent in present value because their retirement age is going to be 67 rather than 65 and their benefits are going to be taxed, probably 100 percent, under the income tax—because there will be bracket creep with respect to the level beyond which benefits are taxed—this is all news to them.

So they are thinking, I think, that things in the future will be better than they actually are slated to be. So we have an education program here. The youth of America needs to be educated that the future is not to be so rosy.

They really need to provide for themselves to a large extent.

**Mr. Dorgan.** Mr. Bosworth, any suggestions?

**Mr. Bosworth.** I think that the problem is overstated. First of all, almost all saving that people do, as I tried to emphasize before in this country, is done before they ever get their hands on the money. That is done through pension-type programs and deductions from this payroll.

Second, if you will look at the flow of funds data of the United States, the two big groups that stand out in this country for increasing their use of debt is not households. It is business and Government. There simply isn't an expansion of consumer debt relative to income at all out of line with the historical pattern.

Finally, the Congress moved in 1986 to make what John Makin, I would think, would identify as a very appropriate adjustment. It is phasing out the tax deductibility of interest payments on consumer debt.

Therefore, it seems to me the Government has done about all it can in that area.

Most Americans I think would resent the insinuation that they are being forced to spend in ways they don't want to spend by advertising. I do not think that in the aggregate there is any evidence that this is a serious problem or the cause of the decline of the private savings rate.

Mr. DORGAN. Thank you very much.

The points that were made earlier by the ranking minority member on capital gains and capital accumulation are something I want to address later. I think that was an interesting discussion.

That is something we need to discuss.

Thank you very much.

Chairman ROSTENKOWSKI. Gentlemen, thank you very much. I enjoyed it.

Senator Roth, Senator Heinz.

Thank you for joining us this morning. I am sure the committee, Senator Roth, is ready to receive your testimony. Immediately following your testimony, we will take the testimony of Senator Heinz.

We are glad you could make it over here today and join us in this discussion.

## STATEMENT OF HON. WILLIAM V. ROTH, JR., A U.S. SENATOR FROM THE STATE OF DELAWARE

Senator ROTH. Thank you, Mr. Chairman.

Gentlemen, I appreciate the opportunity of being here today. I have a more full statement than the one I will read. I would ask that it be included in its entirety.

Chairman ROSTENKOWSKI. Both your statements will be included in the record, without objection.

Senator ROTH. I do want to congratulate you, Mr. Chairman, for holding these hearings on the necessity of increasing savings. Private saving is essential to finance new investment for increased productivity.

In my judgment, increased productivity is necessary to improve U.S. international competitiveness and provide continued gains in the U.S. standard of living. My judgment again is that the Tax Code is an effective way of encouraging private savings.

I think there are several reasons for the low U.S. personal savings rate. They include tax policy, demographics, and possibly cultural factors. A fundamental tax policy problem is the bias against saving in any income tax system. Under an income tax, saving is taxed as income first and then the return to saving is taxed yet again.

For example, when one of my constituents puts her paycheck in the bank, she pays tax on the paycheck itself, and then a whole string of taxes on the interest she earns. This multiple taxation increases the price of saving relative to consumption.

Now, if my constituent had bought a piece of furniture instead of banking her paycheck, she would never have to pay taxes again on that paycheck. This multiple taxation of savings simply doesn't make economic sense for America in a competitive world economy.

We ought to move our Tax Code gradually away from this antisaving bias. At each opportunity, we should look for options which would take qualified saving out of the tax base. By reducing the multiple taxation of savings, the price of saving relative to consumption will be lowered, rewarding thrift.

Obviously, there are many different ways of structuring such incentives and most would have to be offset by other sources of revenue.

I would ask you to consider who is most likely to contribute to our savings base and how we might encourage them to do so. We should be looking for a way to encourage savings by almost all taxpayers.

Economists tend to look at saving activity coldly and by aggregate totals. We have to break away from the umbers for a moment, move away from the idea that only the saving of the rich counts, and find a way to shift savings attitudes across the board.

Who should save? In my view, everyone should save at least a little. We need to find a way to make this possible. The old pre-tax reform IRA was not progressive enough to have broad political appeal. Current rules are too restrictive for the middle class and provide too little incentive for the low-income taxpayers.

To solve these problems, a more direct tax benefit could be offered to the lower income taxpayer—a savings credit—to encourage the kind of national savings policy I envision. The problem that exists now is that the 15-percent tax benefit that results from an IRA contribution is not enough incentive for the poor to save.

However, a savings credit would increase the 15-percent benefit significantly so that working Americans can remain self-sufficient through their own savings. Why a savings credit?

As these hearings make clear, increased savings is critical for our economic strength and the Tax Code should be tilted to encourage savings. In addition, income limitations could be lifted for middle income taxpayers.

Though the vehicle should remain primarily a retirement plan, we should allow temporary withdrawals for health emergencies, home ownership, and college education. Other problems like the current spousal penalty that denies otherwise pensionless spouses from deducting an IRA contribution should be corrected.

Also, in this category are pensioners who have not yet vested and may never vest in their current pension. They are denied the IRA benefit.

Turning from personal savings to another part of the total savings picture, we need a Federal budget policy with some teeth in it. That is why Mr. Frenzel and I introduced yesterday "the Fiscal Guarantee Act." Our bill would provide the President with enhanced rescission authority in the event that other efforts to reduce the deficit are unsuccessful.

We are trying to fix a well-used loophole in the present budget system. Once the Gramm-Rudman target for the year is met and the threat of sequestration has passed, there has been little restraint on actual spending. We must set up a back-stop for the present system which would reduce the budget deficit.

Thank you, Mr. Chairman. That concludes my statement.

[The statement of Senator Roth follows:]

## STATEMENT OF SENATOR WILLIAM V. ROTH, JR.

## BEFORE THE WAYS AND MEANS COMMITTEE

APRIL 19, 1989

THANK YOU, MR. CHAIRMAN, MR. ARCHER AND MEMBERS OF THE COMMITTEE, FOR THE OPPORTUNITY TO APPEAR BEFORE YOU TODAY. I CONGRATULATE YOU FOR HOLDING THESE IMPORTANT HEARINGS ON THE NECESSITY OF INCREASING SAVING. PRIVATE SAVING IS ESSENTIAL TO FINANCE NEW INVESTMENT FOR INCREASED PRODUCTIVITY. INCREASED PRODUCTIVITY IS NECESSARY TO IMPROVE U.S INTERNATIONAL COMPETITIVENESS AND PROVIDE CONTINUED GAINS IN THE U.S. STANDARD OF LIVING. AND THE TAX CODE IS AN EFFECTIVE WAY OF ENCOURAGING PRIVATE SAVINGS.

### ECONOMIC SUMMARY

AS RANKING REPUBLICAN MEMBER OF THE JOINT ECONOMIC COMMITTEE, I AM PARTICULARLY INTERESTED IN CONCENTRATING OUR ATTENTION ON PRIVATE SAVING. WHILE GROSS SAVING CAN BE INCREASED BY REDUCING THE FEDERAL DEFICIT AND THUS REDUCING GOVERNMENT DISSAVING, THIS ALONE DOES NOT ADDRESS THE PROBLEM. IN RECENT YEARS, THE BUDGET DEFICIT HAS BEEN REDUCED SHARPLY FROM ITS HIGHEST LEVEL IN 1986, BUT GROSS SAVINGS AS A PERCENT OF GNP HAS DECLINED. MY POINT IS THAT THE BUDGET DEFICIT IS ONLY PART OF OUR SAVING PROBLEM.

ONE REASON FOR THE RECENT DECLINE IN GROSS SAVING IS THAT PERSONAL SAVINGS DROPPED IN EACH OF THE THREE YEARS AFTER 1984. FROM A LEVEL OF $164.1 BILLION IN 1984, IT HAD SLIPPED TO $104.2 BILLION IN 1987. THIS 36 PERCENT DECLINE IN THE AMOUNT OF PERSONAL SAVINGS IS CAUSE FOR CONCERN.

ALTHOUGH THE COMMERCE DEPARTMENT REPORTED THAT PERSONAL SAVINGS HAD RISEN SOMEWHAT IN 1988, THE LEVEL WAS NOT HIGH BY HISTORICAL STANDARDS AT $144 BILLION. WHILE THIS IMPROVEMENT IS ENCOURAGING, THE 1984 PERSONAL SAVINGS LEVEL WAS 14 PERCENT HIGHER THAN IN 1988. THE CURRENT LEVEL OF PERSONAL SAVINGS IS GROSSLY DEFICIENT TO FINANCE THE NEW CAPITAL NEEDED TO MEET THE INTERNATIONAL CHALLENGES OF THE 1990s.

ANOTHER WAY TO ANALYZE THIS ISSUE IS TO REVIEW TRENDS IN PERSONAL SAVINGS AS A PERCENT OF DISPOSABLE PERSONAL INCOME. ACCORDING TO THIS MEASURE, THE SAVINGS RATE HAS BEEN FALLING THROUGHOUT MOST OF THIS DECADE. BY 1987, THE PERSONAL SAVINGS RATE AMOUNTED TO ONLY 3.2 PERCENT, DOWN FROM 7.1 PERCENT IN 1980. THIS TREND IN THE PERSONAL SAVINGS RATE IS DISTURBING

BECAUSE SAVINGS BEHAVIOR IS LESS DIRECTLY RELATED TO POLICY THAN, SAY, THE BUDGET.

THE PERSONAL SAVINGS RATE DID RISE TO 4.2 PERCENT IN 1988, BUT THIS IS STILL QUITE LOW BY HISTORICAL STANDARDS. THOUGH THERE HAVE BEEN SOME PRELIMINARY SIGNS OF FURTHER PROGRESS IN THE EARLY MONTHS OF THIS YEAR, U.S. PERSONAL SAVINGS RATES WILL LIKELY REMAIN LOW FOR THE FORESEEABLE FUTURE. ONE MEASURE OF HOW FAR WE HAVE TO GO IS TO COMPARE OUR PERFORMANCE WITH THAT OF OUR INTERNATIONAL COMPETITORS.

THE U.S. SAVINGS RATE IS A FRACTION OF THAT OF OTHER MAJOR INDUSTRIALIZED NATIONS. IN 1985 THE PERSONAL SAVINGS RATE IN THE U.S. WAS 4.5 PERCENT (ADJUSTED), IN JAPAN 16.0 PERCENT, IN WEST GERMANY 13.2 PERCENT, IN THE U.K. 11.3 PERCENT, AND IN FRANCE 12.2. PERCENT. IT'S NO WONDER THAT THE U.S. IS AT A COMPETITIVE DISADVANTAGE!

THERE ARE SEVERAL REASONS FOR THE LOW U.S. PERSONAL SAVINGS RATE. THEY INCLUDE TAX POLICY, DEMOGRAPHICS, AND POSSIBLY CULTURAL FACTORS. IF BAD POLICY OVER TIME IS UNDERMINING PRIVATE SAVINGS INCENTIVES, IT MAY TAKE SOME TIME BEFORE ANY CHANGE IN POLICY COULD LEAD TO IMPROVEMENT.

PERHAPS ONE OF THE MOST GLARING EXAMPLES OF HOW THE TAX CODE AFFECTS PEOPLE'S SAVINGS/CONSUMPTION DECISIONS WAS THE DEDUCTIBILITY OF CONSUMER INTEREST UNDER THE OLD CODE. THIS SUBSIDY FOR DEBT WAS WIDELY VIEWED AS ECONOMICALLY IRRATIONAL. CONSUMER INTEREST DEDUCTIBLITY PROVIDED A TAX INCENTIVE FOR ADDITIONAL CONSUMPTION. AT LEAST IN THIS CASE, THERE WAS A CONSENSUS ON THIS COMMITTEE AND IN THE LARGER TAX COMMUNITY THAT TAXATION CAN AFFECT THE DECISION OF WHETHER TO SAVE OR CONSUME. OF COURSE, CONSUMER INTEREST DEDUCTIBILITY IS NO LONGER AN ISSUE UNDER THE NEW TAX LAW.

A MORE FUNDAMENTAL TAX POLICY PROBLEM IS THE BIAS AGAINST SAVING IN ANY INCOME TAX SYSTEM. UNDER AN INCOME TAX, SAVING IS TAXED AS INCOME FIRST, AND THEN THE RETURN TO SAVING IS TAXED YET AGAIN. FOR EXAMPLE, WHEN ONE OF MY CONSTITUENTS PUTS HER PAYCHECK IN THE BANK, SHE PAYS TAX ON THE PAYCHECK ITSELF AND THEN A WHOLE STRING OF TAXES ON THE INTEREST SHE EARNS. THIS MULTIPLE TAXATION INCREASES THE PRICE OF SAVING RELATIVE TO CONSUMPTION. IF MY CONSTITUENT HAD BOUGHT A PIECE OF FURNITURE INSTEAD OF BANKING HER PAYCHECK, SHE WOULD NEVER HAVE TO PAY TAXES AGAIN ON THAT PAYCHECK. THIS MULTIPLE TAXATION OF SAVINGS SIMPLY DOESN'T MAKE ECONOMIC SENSE FOR AMERICA IN A COMPETITIVE WORLD ECONOMY.

WE OUGHT TO MOVE OUR TAX CODE GRADUALLY AWAY FROM THIS ANTI-SAVING BIAS. AT EACH OPPORTUNITY, WE SHOULD LOOK FOR OPTIONS WHICH WOULD TAKE QUALIFIED SAVING OUT OF THE TAX BASE.

BY REDUCING THE MULTIPLE TAXATION OF SAVINGS, THE PRICE OF SAVING RELATIVE TO CONSUMPTION WILL BE LOWERED, REWARDING THRIFT. OBVIOUSLY, THERE ARE MANY DIFFERENT WAYS OF STRUCTURING SUCH INCENTIVES. AND MOST WOULD HAVE TO BE OFFSET BY OTHER SOURCES OF REVENUE.

## TAX SUMMARY

WHEN EXPLORING INCENTIVES FOR INCREASING THE SAVING RATE IN THE U.S., I FIND THAT I BEGIN BY ASKING FOUR FUNDAMENTAL QUESTIONS: WHAT, WHERE, WHO AND HOW.

I BEGIN WITH WHAT OUR BASIC GOAL IS IN PROVIDING TAX INCENTIVES TO SAVE. I BELIEVE THERE ARE TWO. THE FIRST IS THAT WE MUST PROVIDE THE CAPITAL NECESSARY FOR THE FUTURE OF THIS COUNTRY TO STAY COMPETITIVE WITH THE WORLD ECONOMY THAT IS EMERGING. CLEARLY WE HAVE MOVED FROM A NATION OF CAPITAL INTENSIVE INDUSTRY, TO ONE RELIANT UPON THE IDEAS OF OUR ENTREPENUERS. TO THE EXTENT THAT WE HAVE HAVE ELIMINATED TARGETED TAX SAVINGS FOR CAPITAL GOODS, SUCH AS THE INVESTMENT TAX CREDIT, AND REPLACED IT WITH LOWER RATES WE HAVE ENCOURAGED THE MOST EFFICIENT USE OF SAVINGS -- THROUGH THE FREE MARKET SYSTEM. WE MUST CONTINUE THIS TREND.

I BELIEVE OUR SECOND IMPORTANT GOAL SHOULD BE TO ENCOURAGE FINANCIAL INDEPENDENCE. TO THE EXTENT WE CAN ENCOURAGE PRIVATE SAVING, SOCIAL NEEDS SUCH AS EDUCATION, HOMEOWNERSHIP, HEALTH CARE, RETIREMENT AND OTHER WORTHY GOALS WILL BE ATTAINABLE. WE MUST ENCOURAGE PEOPLE TO BE SELF-SUFFICIENT, RATHER THAN SETTING UP COSTLY NEW GOVERNMENT PROGRAMS BASED ON THE CURRENT MULTIPLE TAXES ON SAVING.

MY NEXT QUESTION IS WHERE ANY INCREASE IN THE NATIONAL SAVINGS COULD BEST BE USED. TYPICALLY FINANCIAL INTERMEDIARIES, SUCH AS BANKS, BROKERAGES AND THRIFT INSTITUTIONS, ARE THE MOST EFFICIENT MEANS OF ACHIEVING THIS GOAL BECAUSE THEY FUNNEL MONEY DEPOSITED BY SAVERS TO INVESTORS, CREATING A DECENTRALIZED SYSTEM FOR MAXIMIZING ECONOMIC RETURNS. FROM A COMPETITIVE STANDPOINT, WE MUST ENCOURAGE THE ACCUMULATION AND RETENTION OF FUNDS IN OUR NATION'S FINANCIAL INTERMEDIARIES.

FINALLY, I WOULD ASK YOU TO CONSIDER WHO IS MOST LIKELY TO CONTRIBUTE TO OUR SAVINGS BASE AND HOW WE MIGHT ENCOURAGE THEM TO DO SO.

WE SHOULD BE LOOKING FOR A WAY TO ENCOURAGE SAVINGS BY ALMOST ALL TAXPAYERS. ECONOMISTS TEND TO LOOK AT SAVING ACTIVITY COLDLY AND BY AGGREGATE TOTALS. WE HAVE TO BREAK AWAY FROM THE NUMBERS FOR MOMENT, MOVE AWAY FROM THE IDEA THAT ONLY THE SAVING OF THE RICH COUNTS, AND FIND A WAY TO SHIFT SAVINGS ATTITUDES ACROSS THE BOARD. WHO SHOULD SAVE? IN MY VIEW, EVERYONE SHOULD SAVE, AT LEAST A LITTLE. WE NEED TO FIND A WAY TO MAKE THIS POSSIBLE.

THEORETICALLY, THE BEST ANSWER FOR HOW TO ENCOURAGE SAVINGS WOULD BE TO PERMIT ALL NEW SAVINGS TO AVOID TAX. UNDER OUR CURRENT INCOME TAX MODEL, THIS WOULD BE DONE BY ALLOWING A TAXPAYER TO DEDUCT ANY NEW SAVINGS FROM HIS INCOME BEFORE ARRIVING AT TAXABLE INCOME. THE LOOPHOLE THAT MUST BE AVOIDED UNDER THIS MODEL IS THE MERE "SHIFTING" OF ASSETS, RATHER THAN THE CREATION OF "NEW" SAVINGS. HOWEVER, I BELIEVE THERE ARE METHODS BY WHICH YOU COULD CLOSE THIS LOOPHOLE, AND I INTEND TO EXPLORE THEM.

ASSUMING THAT SUCH AN "IDEAL" PROPOSAL WOULD BE TOO EXPENSIVE, I WOULD ENCOURAGE THE COMMITTEE TO LOOK AGAIN AT A BROAD INDIVIDUAL SAVINGS ACCOUNT, LIKE THE IRAs. IRAs ARE SIMILAR TO THE MODEL OUTLINED ABOVE. HOWEVER, THE OLD PRE-TAX REFORM IRA WAS NOT PROGRESSIVE ENOUGH TO HAVE BROAD POLITICAL APPEAL AND CURRENT RULES ARE TOO RESTRICTIVE FOR THE MIDDLE-CLASS AND PROVIDE TOO LITTLE INCENTIVE FOR LOW INCOME TAXPAYERS.

TO SOLVE THESE PROBLEMS, A MORE DIRECT TAX BENEFIT COULD BE OFFERED TO THE LOWER-INCOME TAXPAYERS--SIMILAR TO THE EARNED INCOME CREDIT BUT DEVOTED TOWARD SAVINGS--TO ENCOURAGE THE KIND OF NATIONAL SAVINGS POLICY I ENVISION. THOUGH THE VEHICLE SHOULD REMAIN PRIMARILY A RETIREMENT PLAN, WE SHOULD ALLOW TEMPORARY WITHDRAWALS FOR HEALTH EMERGENCIES, HOMEOWNERSHIP AND COLLEGE EDUCATION. THE INCOME LIMITATIONS COULD BE LIFTED FOR THE MIDDLE-INCOME TAXPAYERS. OTHER PROBLEMS, LIKE THE CURRENT "SPOUSAL PENALTY" THAT PROHIBITS OTHERWISE PENSIONLESS SPOUSES FROM DEDUCTING AN IRA CONTRIBUTION SHOULD BE CORRECTED. ALSO IN THIS CATEGORY ARE PENSIONERS WHO HAVE NOT YET VESTED, AND MAY NEVER VEST IN THEIR CURRENT PENSION, THAT ARE DENIED THE IRA BENEFIT.

## GOVERNMENT SAVINGS

TURNING NOW FROM PERSONAL SAVING TO ANOTHER PART OF THE TOTAL SAVINGS PICTURE, WE NEED A FEDERAL BUDGET POLICY WITH SOME TEETH IN IT. THAT IS WHY MR. FRENZEL AND I ARE INTRODUCING COMPANION BILLS IN THE HOUSE AND SENATE, CALLED "THE FISCAL GUARANTEE ACT". OUR BILL WILL PROVIDE THIS PRESIDENT, OR A FUTURE ONE, WITH ENHANCED RESCISSION AUTHORITY IN THE EVENT THAT OTHER EFFORTS TO REDUCE THE DEFICIT ARE UNSUCCESSFUL.

HAVING AGREED TO THE GRAMM-RUDMAN LAW, THE CONGRESS AND THE PRESIDENT HAVE EMBARKED TOGETHER ON A PATH TO A BALANCED BUDGET BY 1993. IF THE ANNUAL DEFICIT IS BELOW THE MAXIMUM AMOUNTS ESTABLISHED BY GRAMM-RUDMAN AND WE MAINTAIN A BALANCED BUDGET THEREAFTER, THIS ENHANCED RESCISSION AUTHORITY WOULD NOT BE NECESSARY. IF, HOWEVER, THE DEFICIT OVER THE REMAINING YEARS

OF THE GRAMM-RUDMAN CONSTRAINTS EXCEEDS THE MAXIMUM AMOUNT SET BY GRAMM-RUDMAN, THEN WE SHOULD TRY SOMETHING NEW. UNDER THIS PROPOSAL ENHANCED RESCISSION AUTHORITY WOULD TAKE EFFECT BY 1993 IF OTHER CONSTRAINTS FAIL. WE ARE TRYING TO FIX A WELL-USED LOOPHOLE IN THE PRESENT BUDGET SYSTEM, NAMELY ONCE THE TARGET FOR THE YEAR IS MET, AND THE THREAT OF SEQUESTRATION HAS PASSED, THERE IS LITTLE RESTRAINT ON ACTUAL SPENDING. WE MUST SET UP A BACKSTOP FOR THE PRESENT SYSTEM WHICH WOULD FORCE PROGRESS OVER THE NEXT SEVERAL YEARS.

I WOULD LIKE TO THANK YOU FOR YOUR TIME AND WOULD BE HAPPY TO ANSWER ANY QUESTIONS THAT YOU MIGHT HAVE.

Chairman ROSTENKOWSKI. Senator Heinz.

## STATEMENT OF HON. JOHN HEINZ, A U.S. SENATOR FROM THE STATE OF PENNSYLVANIA

Senator HEINZ. It is good to be back with the Ways and Means Committee, the people's body. Normally, when we are invited over here, it is only to take a minor role in a conference that the House chairs.

Chairman ROSTENKOWSKI. Senator, flattery will get you nowhere in this committee.

Senator HEINZ. One's hope springs eternal, Mr. Chairman.

Chairman ROSTENKOWSKI. I was just told by Jake Pickle he likes to hear it. If you want to continue, that is all right.

Mr. PICKLE. I would say Mr. Heinz and Mr. Pickle like to work together.

Senator HEINZ. And we have the Heinz-Pickle bill to prove it.

I ask unanimous consent my testimony be placed in the record as given in full.

Chairman ROSTENKOWSKI. Without objection.

Senator HEINZ. Mr. Chairman, there have been a lot of excellent ideas proposed here today. I like a lot of them. I like the idea of reducing the Federal deficit. I think we all do. I think the idea of an increasing return on equity by reducing or eliminating the double taxation of equity is a good idea.

The subject of developing a national retirement income policy was somewhat less touched on, but a national income—retirement income policy that diminishes dependence on Social Security by augmenting other sources, especially by expanding our private pension system, by some means, either Bill Roth's or other means, would be very desirable.

I have to say unfortunately, virtually every revenue and reconciliation bill since 1981 has gone the other direction, by reducing pension funding and payout limits or eliminating IRA's, all in the name of raising revenues. It is, in my judgment at least, a very shortsighted policy that you can mathematically demonstrate, even as with eighth grade math, that it has cost far more in pension contributions and, therefore, national savings than we have gained in deficit reduction.

It is really a classic example of eating your own seed corn.

But we are currently engaged in plundering an even greater source of national savings, namely, the Social Security Trust Fund Reserves. I suspect this committee is as familiar as any group in Washington on what we are doing. What we are doing, though, for the benefit of those in the audience that may not follow this, is that when we report the wonderful progress that we are making on the deficit under the Gramm-Rudman-Hollings Deficit Reduction Act, we treat as if it were deficit reduction the annual increment of Social Security revenues that exceed Social Security expenditures.

We tend to avoid making a lot of public statements about that. It is a little embarrassing to us to have to say, well, the deficit is coming down but the national debt is not, it is going up. But we will reach a day of reckoning very shortly, Mr. Chairman, where in 1993, assuming we stick to our guns and do what we have to do, we will get to a situation where the budget is reported as balanced and the national debt will increase, if you count what is owed both to the Social Security Trust Fund and to everybody else, by 70 or $80 billion a year and that is just for openers.

Because once again we will continue to use the Social Security surpluses on each year as if they were deficit reduction. Nobody is proud of that. I realize that, Mr. Chairman.

In addition to proposing, as I have in legislation, that we should, starting next year, freeze the amount that we are counting, which will be roughly $60 billion, and then deal with that in one or two or three slices after 1993 so we really stop that budget accounting gimmickry.

What I would really like to focus on is the opportunity that would be created for this country were we to do that. Larry Thomas of the General Accounting Office, who had a great deal to do with the GAO January report on Social Security and the reserve accumulation will tell you that if we would basically do what I have suggested, or what Pat Moynihan has suggested, and perhaps some of you have suggested, by the year 2007, maybe a little earlier, we would have been able to buy in the entire national debt that the Treasury has to go in and refinance at the beginning of every week. Talk about a boon to national savings.

That is only 17 or 18 years away. What a legacy to leave to our children of no Treasury financing. There would still be debt. Don't misunderstand me. We would have roughly a $2.7 trillion, perhaps a bit more, national debt, but we would not be out there competing with homebuyers, business people, all the people who need credit in this society.

I think you would see a major increase in the national savings rate. That at least is the conclusion not only of the General Accounting Office, but the National Economic Commission which I think the Chairman has some passing familiarity with.

There was only one recommendation the members of the National Commission agreed upon. It was to save the reserves in the Social Security system, not to use them for deficit reduction, but use them, as I have suggested, to increase, our national savings rate. I know people who were on that commission were frustrated. If they achieved nothing else than to get a consensus on that subject, they have performed an enormous national service.

Thank you, Mr. Chairman.

[The statement of Senator Heinz follows:]

NEWS FROM
**SENATOR JOHN HEINZ**
SPECIAL COMMITTEE ON AGING
Senate Hart 628 Washington, D.C. 20510-6400 (202) 224-1467

## TESTIMONY OF SENATOR JOHN HEINZ
## BEFORE THE COMMITTEE ON WAYS AND MEANS
## APRIL 19, 1989

Mr. Chairman. I commend you for holding this very important and very timely hearing to examine long term strategies for increasing our national savings rate.

Debt historically, has been a four-letter word around Washington. With the exception of wartime obligations--that which Alexander Hamilton called "the price of liberty"--the Congress has eschewed debt as an "infidelity to the public," the surest road from economic vigor to financial anemia.

But in the past eight years, traditional Federal prudence has vaporized in a mist of deficit spending -- and with it, national savings. Our national debt increased by $156 percent, from $794 billion in 1981, to the current $2.6 trillion. Just last year we borrowed $158 billion from foreign investors--more than the government spent for farm aid, housing, education, unemployment compensation, veterans' benefits, post office, and highways combined.

With growing debt comes shrinking personal savings. Americans saved only 4% of their incomes last year, compared to 7% six years ago. Almost all domestic personal savings are now being consumed by government deficits. At the same time, government deficits have risen from historical levels of about 1 to 2% of GNP to an average 5% of GNP in the 1980s. This combination has dropped net national savings from 6% of NNP in 1981 to only 2% in 1987.

To its credit, a debt-bound, interest-ridden Congress awoke to the need for self-restraint in 1986, and enacted the Gramm-Rudman-Hollings plan to eliminated the deficit by 1993. On the books there is hope for taming the ravenous debt. But in reality, we will be over $100 billion short of a zero deficit target four years from now because of some highly creative fiscal fakery.

To ease the process of unpopular spending cuts, federal lawmakers have written themselves a $2.7 trillion line of credit against surpluses in the Social Security Trust Fund. Trust Fund surpluses are "borrowed" and counted on the ledger as annual revenues to make the deficit appear smaller than it actually is--$39 billion smaller in 1988, for example. If unchecked, this clandestine borrowing will double the national debt in ten years to staggering $5.4 trillion.

Real Social Security savings - - achieved by not lending and spending reserves on current programs - - will be essential if we are ever to get our national savings rate back to levels we knew in the 1970s. We must separate Social Security from the G - R - H deficit targets and force ourselves to reduce all of the remaining deficit. At a minimum, we need to prevent Social Security's contribution to the budget from growing and casting an ever larger shadow over the deficit -- at least until we reach Gramm-Rudman's zero deficit target in 1993. Then we can take the additional two or three years we will need to work the remaining Social Security surpluses out of the budget. This is the thrust of legislation I introduced in the 101st S. 240.

The most important benefit of creating a true Social Security reserve will be its contribution to real savings in the economy. With budget deficits eliminated, Social Security's reserves would be able to buy in and replace our $2.6 trillion of publicly held debt by 2007. By freeing up private savings to meet our need for domestic investment capital, we would not only reduce our dependence on foreign capital, but we would substantially reduce the cost of capital to Americans and substantially increase our competitive posture in the world.

Economic growth is our key to success. With adequate growth we can pay those costs with no great added burden for tomorrow's workers. The more growth and productivity we have, the more manageable tomorrow's costs will be. Low inflation and interest rates and high real wages will keep the Government's costs down and revenues up. Doing something now to create additional savings to stimulate that growth will have the doubly satisfying result of making our problems more manageable and proving current doom and gloom predictions wrong.

The handcuffing of future generations with unpaid debt and the involuntary diversion of their revenues to debt service will place an added burden on their workers -- a burden that will make it harder for them to invest in human capital, meet the retirement costs of their time, and stimulate continued growth in the economy.

Mr. Chairman, I appreciate this opportunity to speak on this issue of personal interest and great national consequence. I look forward to working with you and with our Colleagues in both the House and Senate in bringing some resolution to our national savings crisis.

* * * * * *

Chairman ROSTENKOWSKI. Once again, I want to express my gratitude for your participation. I think it behooves us no end to look to the future and to look at what we are going to be doing with respect to the participation of your committee in the Senate and our committee here on this side of the Congress.

Are there any questions?

Mr. Moody.

Mr. MOODY. Thank you very much.

Senator, are you saying by the year 2007, if we just do nothing, that the Social Security surplus will have gobbled up the entire—along the lines Moynihan pointed out?

Senator HEINZ. If we do nothing, no, that will not happen. Nothing is the status quo where we keep using the annual increment as if it were a genuine deficit reduction.

Mr. MOODY. I don't mean that. I mean the legal requirement that social security trust funds be placed in surplus—be used only in the Federal debt.

Senator HEINZ. That is for all intents and purposes what the requirement is now.

Mr. MOODY. So by the year 2000, you are saying the——

Senator HEINZ. 2007.

Mr. MOODY. The entire backlog of debt will be purchased in this fashion, is that what you are saying?

Senator HEINZ. That is correct. If we discipline ourselves on the other side.

Mr. MOODY. If we don't spend it, you mean?

Senator HEINZ. Yes.

Mr. MOODY. Suppose we bring the deficit, the nominal deficit down to zero. But part of that is the Social Security surplus and by 1993, if we stick to our guns. Even if we keep counting the Social Security surplus in the unified budget, we still will not have done what you are saying; namely, not be in the capital market competing with homebuyers for the private savings?

We will have forced ourselves to save through the Social Security withholding system. Really, it is another tax.

Senator HEINZ. Actually, that is not what would happen.

Mr. MOODY. Explain what would happen.

Senator HEINZ. What would happen is that you would—the general public would continue to hold what will, by the year 1993, be roughly 2.7 or $3 trillion of federally issued debt.

Mr. MOODY. Right now it is 2.9.

Senator HEINZ. Whatever that number works out to be. Maybe $3.5 trillion. What is a half-a-trillion dollars among friends?

In addition to that, the Federal Government will owe to the Social Security trust funds another increment of debt, say, of roughly between $2 and $3 trillion between now and the year 2007. The consequences will be that interest payments, for example, relative to what they might otherwise be, if we didn't do that, will be about twice what they would be.

This committee understands exactly what that interest does. It doesn't educate a single kid. It doesn't buy a single tank.

Mr. MOODY. We should take Social Security surpluses out of the unified budget in terms of Gramm-Rudman calculations, balance the budget without the surplus?

Senator HEINZ. Yes, sir.

Mr. MOODY. Did you apply the same reasoning to the S&L bailout? Should we also stop fooling ourselves by taking that off budget?

Should we admit that another entity of Government, called REFCORP, is out there borrowing money in the capital market, thus driving the demand on personal savings?

In other words, isn't the same reasoning required that we be just as honest about the S&L bailout as you would like us to be about the Social Security Trust Fund?

Senator HEINZ. Congressman, I couldn't possibly disagree with your logic. The politics of that issue which we are debating right now on the floor is something else again. You know, the politics of that bill is that I wonder if anybody wants to show up for the bill signing ceremony if we ever have one.

I can see the President turning around and trying to present a pen and there is no one there to take it. That is an issue of doing what we have to to get the job done.

Don't ask me if it is logical? We are proud of it.

Mr. MOODY. What is so dangerous about the politics of admitting the truth? The market knows what is happening. The market knows we are creating a Government entity to borrow money. The market won't be fooled by this accounting artifice.

I don't think the public is that concerned about how we do it, as long as we expeditiously handle it. Frankly, it will cost us $4.5 billion more to do it the way the President is proposing.

Senator HEINZ. Congressman, we had that debate last night on the Senate floor. The vote was about 2-to-1 against that point. It is a perfectly respectable point of view.

Mr. MOODY. You, yourself, don't disagree with it?

Senator HEINZ. The economics are perfectly reasonable if you can hold all—everything else stable. All right? If everything else is equal.

The reason I think that your side of the argument was outvoted last night was that there is good reason to be skeptical that once you take a major problem off budget, that you can avoid taking lots of other major problems off budget.

Mr. MOODY. My argument is don't take it off budget.

Senator HEINZ. We just don't know how to handle that big a hole in the budget.

Mr. MOODY. So——

Senator HEINZ. I am glad you do. I salute you.

Mr. MOODY. Thank you.

Chairman ROSTENKOWSKI. Thank you very much, Senators.

Just as an observation, I understand that yesterday the vote margin was only two votes with respect to taking it off budget?

Senator HEINZ. The vote was 48–50. You needed 60 votes the way—it was—in fact, it was 12 votes short.

Chairman ROSTENKOWSKI. I see.

Well, wouldn't——

Senator HEINZ. You are quite right. I did misspeak. The majority of the Senate still did not agree.

Chairman **Rostenkowski**. Wouldn't, if we kept it on budget, take it outside the purview of Gramm-Rudman-Hollings, wouldn't that solve the problem?

It is just a thought.

Thank you very much, Senators.

Senator **Roth**. Thank you.

Senator **Heinz**. Thank you, Mr. Chairman.

Chairman **Rostenkowski**. Mr. Hatsopoulos, Mr. Roberts, Mr. Pozen, Mr. Steffens.

Mr. **Pickle**. Mr. Chairman, I would like to say for the record, I read Mr. Hatsopoulos' testimony and I noted the comments about the changing shift from equity to debt. Mr. Hatsopoulos, I think you make some good recommendations about the deficit and the national savings rate. I personally think you did a good job regarding leveraged buyouts by suggesting a possible alternative.

While I have to go to another meeting, I want to in advance say I will again look at your interesting testimony, particularly about how we will use the CCDC approach.

Thank you for your appearance here today.

Chairman **Rostenkowski**. Welcome, gentlemen. I appreciate your participating in this discussion. I am sure you all know the format here.

We allow you to testify. If you have a statement longer than five or six minutes, we hope you will summarize so you can give us a chance to have an exchange with you as witnesses.

Mr. Hatsopoulos, please proceed.

## STATEMENT OF GEORGE N. HATSOPOULOS, PH.D., COFOUNDER, AMERICAN BUSINESS CONFERENCE, CHAIRMAN AND PRESIDENT, THERMO ELECTRON CORP., WALTHAM, MASS., AND CHAIRMAN, FEDERAL RESERVE BANK OF BOSTON

Mr. **Hatsopoulos**. Thank you very much, Mr. Chairman.

As the previous panel pointed out, national savings is, of course, the difference between national output and domestic consumption. The decline in national savings seen in 1980, therefore, was the direct result that consumption grew faster than output.

We have released a new study on this subject last March which I coauthored with MIT Professors Krugman and James Poterba in which we are trying to answer some of the questions concerning what has caused the unusual growth in consumption: Mr. Chairman, with your permission, I would like to submit this study for the record.

Chairman **Rostenkowski**. Without objection, so ordered.

Mr. **Hatsopoulos**. I will limit my oral remarks to what we would suggest to relieve this excessive growth in consumption that has caused a decrease in the national savings.

First and foremost, Mr. Chairman, we should, of course, tackle the budget deficit. We know that this committee, working with the administration and the Senate is trying to accomplish this difficult job. There is nothing much we can add, except to wish you good luck and to point out to you, something which I am sure you already know, that deficit reductions increase national savings only to the extent that they slow down the growth of consumption.

This is very much akin with the comments made in the previous panel by the Senators, that sometimes we reduce the budget deficit without, in effect, increasing national savings.

We believe that in addition to the budget deficit reduction, a lot can be accomplished by instituting a national program to induce Americans to save. Based on our collective experience at the American Business Conference and among the CEOs that participate in it, experience that deals with many thousands of employees, we believe that such a program should emphasize the following features.

It should be easy for people to understand. It should be available and valuable to households regardless of tax brackets.

It should induce a regular pattern of savings rather than encourage portfolio reshuffling.

Of course, we should try to structure it in such a way that the cost to the Government is at a minimum.

And finally, we believe that such a program can be successful only if there is a national campaign that both Congress and the administration and the business community participate in so as to convince the American people that it would be to their long-term advantage to do so.

Our final recommendation has to do with the findings that leveraged buyouts and debt finance takeovers have contributed to increased consumption, and, therefore, reduce national savings. We have a chart here that shows the extent to which equity issues—new equity issues—have turned out negative and have been substituted with increased corporate debt.

The total amount since 1984 was $400 billion. There are probably many reasons for that shift, but one of the most obvious ones is that the total taxation of debt, which was about the same as the total taxation of equity in the 1980's, has shifted by a large amount towards favoring debt financing. We strongly recommend that an adjustment be made to bring back the equilibrium, and avoid favoring debt over equity. This was the case in this country in 1980 and it is still the case all over the industrialized world.

This adjustment should be done in a way that does not increase either the cost of capital nor the budget deficit. One plan that has satisfied these objectives is outlined in my written testimony. It essentially involves replacement of the current interest deduction with a uniform capital cost reduction.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you.

[The statement of Mr. Hatsopoulos and the study referred to follow:]

# TESTIMONY BY GEORGE N. HATSOPOULOS

Chairman and President of Thermo Electron Corporation
Chairman of the Federal Reserve Bank of Boston
Spokesman for the American Business Conference

**Presented to the House Ways and Means Committee**
**April 15, 1989**

Mr. Chairman, thank you for the opportunity to appear before the committee on the critical issue of national saving. I have spent a great deal of time over the past eight years focusing on national saving and the cost of capital. Today, I am testifying both for myself and my colleagues at the American Business Conference. We released a major new study in March on savings entitled, "Overconsumption: The Challenge to U.S. Economic Policy," which I co-authored with MIT professors Paul R. Krugman and James M. Poterba. This study bears directly on the hearings today.

For the first time in America's history, the prosperity of its people is supported not by its production, but by the selling of assets that took many generations to create. The federal budget deficit is widely perceived as the central problem. The deficit is, however, only a contributing factor to a more fundamental problem: excessive consumption relative to output.

The United States is currently consuming a higher fraction of its national income than any other industrialized nation and a far higher fraction than in any comparable period in our history. Our high consumption rate (or equivalently, our low saving rate) is the single most important cause of both unprecedented trade deficits and inadequate domestic investment during the mid-1980s. Restoring national saving at least to the level of the 1970s should be the central goal of national economic policy.

Low saving and overconsumption is mortgaging our future. The U.S. economy has been attracting the capital it needs from abroad by a low dollar that makes our corporations and securities inexpensive in foreign currency. This process affects the future economic growth of our nation in two ways: First, as an increasing share of U.S. assets end up being foreign-owned, a growing share of U.S. output will be claimed by foreigners. Second, inadequate national saving translates into reduced domestic investment. During the late 1980s, the United States has had the lowest rate of net investment, as well as the lowest rate of productivity growth of any major industrial nation. The principal long-run cost of overconsumption is the gradual slowing in the growth of living standards.

The sharp fall in national saving during the 1980s has many sources. The most popular villain -- the federal budget deficit -- accounts for less than half of the decrease. Reduced private saving bears more of the responsibility. Together these factors account for a decline in national saving from 8 percent of national income in the 1970s, to barely 2 percent of national income today.

In our study we trace the recent growth of personal consumption to four primary factors: (i) Growth in households' after-tax income between the 1970s and mid-1980s accounts for roughly one third of the consumption increase. High federal deficits have contributed to the growth in after-tax incomes. (ii) Demographic change, principally the baby-boom generation's entry into high spending age brackets, explains approximately one quarter of the consumption increase. (iii) Higher personal wealth relative to national income, the result of a rising stock market and a climbing stock of government debt, accounts for about one sixth of the rise in consumption. (iv) Finally, the growth of debt-financed takeovers and share repurchases (since 1984 equity retirements have exceeded new issues by more than $400 billion) has also contributed to rising consumption, accounting for nearly one sixth of the consumption growth since the 1970s.

Our surprising finding that debt-for-equity swaps raise consumption can be explained in two ways. First, firms with large amounts of debt in their capital structure are committed to distributing a higher fraction of their earnings than are firms which are mostly equity-financed. This increased cash payout encourages consumption. Second, when corporate shares are repurchased, stockholders receive cash payments. While many investors reinvest the proceeds of involuntary and unanticipated realizations in takeover transactions, a substantial fraction may also increase their consumption.

## Solutions to Overconsumption

Mr. Chairman, slowing the growth of consumption relative to the growth of national income requires prompt action on several fronts. Let me suggest three lines of action, one general and the other two specific. These actions have come from long deliberations among economists and business leaders who contributed to the work on our "Overconsumption" study.

### 1. Reducing the Federal Deficit

Lowering government consumption is the most direct method of attacking the overconsumption problem. Raising taxes, thereby lowering private consumption, will also increase national saving although the net effect is less certain. The differential effect of various tax changes on private saving, and thus national saving, should be recognized.

### 2. Improving Incentives for Private Savings

Introducing a national campaign to promote saving and issuing "Supersaver" bonds to encourage households to save for the long-run could bolster the falling private saving rate.

Supersaving bonds (SSBs) would be an integral part of a program to raise personal saving. The program would emphasize several features. First, the incentive should be available and valuable to households regardless of tax bracket. Second, it should induce a regular pattern of saving, rather than solely encourage portfolio reshuffling. Third, the initiative should come as part of a public campaign for higher saving. Finally, the cost to the government should be kept to a minimum.

SSBs would be similar in design to current U.S. savings bonds. However, SSBs would be subject to more restrictions and, in return, would yield much higher returns. Their return would be higher than traditional savings bonds and over most money market instruments available to the general public. A fixed minimum yield would be determined annually by the Treasury. Like traditional savings bonds, SSBs would be sold at discount for one-half their face amount.

Because their yields are higher, SSBs would reduce sales of traditional savings bonds. However, because they are sold only through payroll deduction plans and only in small denominations, the extent of this reduction is apt to be quite limited.

SSB Annual Limits. Because the primary motivation for SSBs is to provide regular net new saving, SSBs could only be purchased through payroll deduction plans. They would be sold with face values ranging from $25 to $500. Each month's payroll deduction could not be greater than $250, for an annual limit of $3,000 if all twelve monthly purchases were made. (The maximum of $3,000 would purchase SSBs with a face value of $6,000 at maturity.) This requirement would force those employees interested in receiving the full benefit to establish a regular system of payroll deductions.

SSB Yields. Currently savings bonds mature in 12 years for a minimum yield of approximately 6 percent. However, if "market" interest rates (determined as 85 percent of the 5-year Treasury constant-maturity yield) are above 6 percent, then they will yield the market rate. The new SSBs would mature in a shorter period of time to be determined by the Treasury. However, the actual yield in each year would be the higher of the minimum yield, determined the term to maturity, and the actual rate on 5-year constant maturity Treasury notes. Thus SSBs would pay greater interest than traditional savings bonds. Federal income taxes would be paid on SSB interest at redemption. SSBs would be free of state and local income taxes.

**SSB Distribution.** Any financial service company could provide the distribution of SSBs through company payroll plans. The self-employed or unincorporated businesses and partnerships could establish regular deduction plans through banks or other financial service companies. At the purchaser's request, the distributor of SSBs could play a custodial role in the holding of SSBs. The Treasury will determine an appropriate fee for the processing of SSBs. Deposit of SSB receipts into the Treasury's account at the Federal Reserve would be required within 2 weeks of purchase. The processing fee and deposit delay are designed to give a return to providers of SSB payroll deduction plans.

**SSB Redemption Restrictions.** The same restrictions regarding redemption of traditional savings bonds would apply to SSBs. No redemption is allowed in the first 3 months after purchase. Thereafter, the redemption yield would rise slowly from 3 percent to the minimum rate over 5 years. Any redemption made after five years would yield the full interest (the higher of the minimum yield or the market rate).

### 3. Eliminating Tax Incentives for Corporate Leverage

The ongoing shift from equity to debt in the corporate sector has probably been an important cause of low national saving in the 1980s. There are probably many reasons for this shift. The most obvious of these is that tax incentives for corporate borrowing have significantly increased during the last decade. The relative tax burden on debt as compared to equity depends on both corporate and investor rates. The general trend towards reductions in individual tax rates -- from a maximum of 70 percent in 1980 to 28 percent today -- coupled with the elimination of capital gains exclusion and of the investment tax credit (ITC) has significantly reduced the net tax burden on interest payments relative to that on retained earnings and dividends. Thus, the attraciveness of debt over equity was significantly enhanced.

Mr. Chairman, it is important to eliminate the differential tax treatment of debt and equity to slow the tax-induced replacement of debt for equity in corporate capital structure. The most attractive proposals are those which reduce, or at least do not increase, either the cost of capital or the federal deficit. One plan which satisfies this objective is replacement of the current interest deduction with a uniform capital-cost deduction (UCCD).

The UCCD would allow firms to deduct from income a fixed percent of both their equity and debt. After a transition period of five years, businesses would no longer be able to deduct interest on debt against their income taxes (other than interest related to a long-term debt obligation made before January 1, 1989). Instead they would be able to deduct a fixed percent of their total capitalization including both equity and debt. By reducing the deductibility of returns to debt and increasing the deductibility of returns to equity, the UCCD would increase the attractiveness of equity over debt and halt the unprecedented surge in corporate debt. Moreover, the UCCD would lower the cost of equity by more than the recently proposed return to a limited capital-gains exclusion on personal income taxes.

Total capitalization under the UCCD is equal to the average annual level of debt plus a measure of equity calculated as the audited average of a firm's start-of-year and end-of-year stockholder equity. Debt would be defined as any financial obligation to a third party that incurs an interest cost greater than the uniform deduction rate. For instance, if the Treasury determines that the uniform deduction rate is 5 percent, any loan, note or other financial obligation with an interest rate greater than or equal to 5 percent would be debt. Any obligation with an interest cost less than 5 percent could not be counted as debt. This provision is necessary to prevent corporations from defining as debt other liabilities such as accounts payable.

The UCCD is designed to be revenue neutral. The deduction rate would, at introduction, be established by the Treasury so that its revenue loss would just equal the revenue gain from disallowing interest deductibility. Once calculated, that deduction rate would change year-to-year by the same amount as the change in the yield on 5-year constant-maturity Treasury bonds. In this way if interest rates rise or fall relative to their levels in the year in which the UCCD is introduced, then the capital-cost deduction will also rise or fall to reflect the higher or lower capital costs in that year.

The only exception to the UCCD is for firms with interest income (primarily financial service firms). Interest expenses could be deducted up to the amount of interest receipts. Without this provision the UCCD would impose a hardship on financial service firms in which interest expense is, in effect, the cost of goods sold.

During a transition period of five years, a firm can elect either to take the UCCD or to retain the current interest deduction. After the transition period, the only allowed interest deduction will be for fixed financial obligations made prior to January 1, 1989. The one exception to this is that small businesses (where the definition of small business would be established by the Treasury) could elect to retain the current interest deduction indefinitely.

Mr. Chairman, I have briefly summarized the two specific suggestions which I have for improving America's national saving problem. I have briefly sketched the details of both solutions. With the Chairman's permission, I would like to submit for the record our newly released study on "Overconsumption."

I would now be happy to answer any questions which you might have.

# Overconsumption:

## The Challenge to U.S. Economic Policy

George N. Hatsopoulos, Paul R. Krugman,
and James M. Poterba

Jointly sponsored by the
American Business Conference and
Thermo Electron Corporation

# Table of Contents

- Acknowledgement 3
- Foreword 4
- Executive Summary 5
- Overconsumption: The Challenge to U.S. Economic Policy 6
  - Introduction 6
  - The Bottom Line 6
  - Short-run Risks of Low National Saving 7
  - Long-run Consequences of Low National Saving 8
  - The Rise of Personal Consumption 9
  - A Strategy to Raise National Saving 11
  - Reducing the Federal Deficit 12
  - Inducing Voluntary Increases in Personal Saving 13
  - Slowing Down the Leveraging of U.S. Corporations 14
  - A Possible Alternative 16
  - Conclusion 16

Appendices:

- I. Determinants of Consumer Spending 17
  - Consumption Function Estimates 17
  - Explaining Consumption Growth, 1970 to 1988 20
  - Sensitivity Analysis 21
- II. Why Has Leverage Increased? 23
- III. Potential Effects of Saving Incentives 26
- IV. Effect of Revenue-Neutral Changes In Corporate Taxation on the Cost of Capital 26

# Acknowledgement

This work benefited greatly from discussion and criticisms from many economists, engineers, and business executives. We are particularly grateful to Martin Feldstein, Dale Jorgenson, Lawrence Summers, and Paul Volcker for their time in reviewing this document and for their constructive suggestions. We also thank the economists of the Federal Reserve Bank of Boston for their input and contribution.

We are particularly indebted to the members of the American Business Conference, and especially to Barry Rogstad, for the interest in the subject of national saving. The impetus emerged from discussions of ABC chief executives during task force meetings on economic policy.

Finally, we wish to recognize the tireless and extraordinary staff support provided by Linda Nordberg of Thermo Electron Corporation.

# Foreword

*Overconsumption: The Challenge to U.S. Economic Policy* is one in a series of working papers sponsored by the American Business Conference. These working papers advance innovative ideas on issues relating to economic growth and capital formation. Deliberately provocative, they are intended to spark discussion and debate regarding how best the United States can stimulate new investment, job creation, and greater international competitiveness.

George Hatsopoulos, the lead author of this working paper, is a founding member of the American Business Conference, chairman and president of Thermo Electron Corporation, and the author of numerous economic monographs including an ABC sponsored ground-breaking study of comparative capital costs. In *Overconsumption: The Challenge to U.S. Economic Policy*, Dr. Hatsopoulos and his collaborators, Professor Paul Krugman and Professor James Poterba of the Massachusetts Institute of Technology, examine one of the most troubling economic phenomena of recent years—the low level of savings in the American economy. They analyze the sources and consequences of the problem and suggest some highly intriguing policy options to address it.

Their paper could not be more timely. Our anemic national savings threatens the nation's capacity to generate sufficient investment necessary to remain competitive in a global market. Indeed, the members of the American Business Conference— the chief executives of one hundred fast-growing, midsize businesses—regard the low level of national savings, which includes government dissaving in the form of chronic federal budget deficits, as the single greatest economic problem confronting the country.

We would like to thank Dr. Hatsopoulos and his co-authors for their efforts. Their paper has already ignited a lively exchange among ABC members and will, we believe, similarly enrich the ongoing dialogue on fiscal issues within the economic policy-making community at large.

*Arthur Levitt Jr., Chairman*
*Barry K. Rogstad, President*

American Business Conference
New York and Washington, March 1989

# Executive Summary

### *Overconsumption: The Challenge to U. S. Economic Policy*

For the first time in America's history, the prosperity of its people is supported not by its production, but by the selling of assets that took many generations to create. The federal budget deficit is widely perceived as the central problem. The deficit is, however, only a contributing factor to a more fundamental problem: excessive consumption relative to output.

The United States is currently consuming a higher fraction of its national income than any other industrialized nation and a far higher fraction than in any comparable period of our history. Our high consumption rate (or equivalently, our low saving rate) is the single most important cause of both unprecedented trade deficits and inadequate domestic investment during the mid-1980s. Restoring national saving at least to the level of the 1970s should be the central goal of national economic policy.

### *The Costs of Overconsumption*

High current consumption poses many threats to the U.S. economy. One is that our dependence on foreign capital and the growing overhang of debt expose the United States to short-run risks. More fundamentally, our high current consumption mortgages our future. Increasingly, the U.S. economy has been attracting the capital it needs by selling our assets cheaply. Foreign investors have been induced to buy up U.S. land, corporations, and securities by a low dollar that makes these assets inexpensive in foreign currency. This process cannot continue indefinitely; ultimately, inadequate national saving must translate into reduced investment. During the late 1980s, the United States had the lowest rate of net investment, as well as the lowest rate of productivity growth, of major industrial countries. The principal long-run cost of overconsumption is a gradual slowing down of the growth of living standards.

### *The Causes of Overconsumption*

The sharp fall in national saving during the 1980s has many sources. The most popular villain – the federal budget deficit – accounts for less than half of the decrease. Reduced private saving bears more of the responsibility. Together these factors account for a decline in national saving from 8 percent of national income in the 1970s, to barely 2 percent of national income today.

Our investigation suggests that four basic factors have played a central role in the decline in saving, or equivalently, the growth of consumption:

- Growth of the federal deficit,
- Changes in the demographic structure of the U.S. population,
- Increased personal wealth, and
- Increased cash payout from firms to investors.

The last factor reflects both the substitution of high-interest-yield debt for low-dividend-yield equity in corporate capital structures, as well as the forced realization of capital gains resulting from debt-financed takeovers and leveraged buy outs.

### *Solutions to Overconsumption*

Slowing the growth of consumption relative to the growth of national income requires prompt action on several fronts:

- *Reducing the Federal Deficit*. Lowering government consumption is the most direct method of attacking the overconsumption problem. Raising taxes, thereby lowering private consumption, will also increase national saving although the net effect is less certain. The differential effect of various tax changes on private saving, and thus national saving, should be recognized.
- *Improving Incentives for Private Saving*. Introducing a national campaign to promote saving and issuing "Supersaver" bonds to encourage households to save for the long-run could bolster the falling private saving rate.
- *Eliminating Incentives for Corporate Leverage*. Equal tax treatment of debt and equity would slow the growth of corporate leverage and thereby reduce the trend toward higher cash payout to shareholders, and bondholders.

# Overconsumption:
## The Challenge to U.S. Economic Policy

### *Introduction*

The single greatest problem of the U.S. economy in the late 1980s is its extremely low level of national saving. The current low national saving rate – the lowest rate we have ever had except in times of war or depression, less than half the rate in the severe recession year of 1982, and by far the lowest rate in the industrial world – lies at the root of both our unprecedented trade deficits and our inadequate level of domestic investment, which in turn is a major cause of low U.S. productivity growth.

Low U.S. national saving is usually blamed primarily on the federal budget deficit. *While the budget deficit was an important contributory factor to the decline in national saving in the 1980s, it was far from the whole story: declining private saving was more important.* Eliminating the budget deficit, therefore, will not eliminate the national saving problem.

From 1985 to 1987 the federal deficit declined substantially. Yet private saving declined even more and, as a result, national saving declined. It therefore appears that there are important factors depressing national saving other than the budget deficit. In other words, a commitment by the United States to eliminate the federal deficit, important as this goal is, is not sufficient. *We need a national policy that focuses on the real bottom line: restoring national saving to at least the level of ten years ago.*

The purpose of this paper is to review the causes and consequences of the low U.S. national saving rate and to propose some policy changes that could help to reverse its alarming decline.

### *The Bottom Line*

Saving for the nation has the same definition as saving for an individual: the excess of income over expenditure for current consumption. For the nation as a whole, saving is defined as the difference between national income and national consumption. National income, in turn, is simply net national product – the value of goods and services produced in the economy, less depreciation of the national capital stock – while national consumption is the sum of private consumption and consumption by the public sector.[1]

Table I shows the relation between national saving, net domestic investment, and net U.S. investment abroad (the current account balance) in the period 1985 to 1987 compared to the period 1970 to 1979, all expressed as a percent of national income.

During the 1970s the United States saved on average 7.9 percent of its national income. Of that, 7.6 percent was invested domestically and 0.3 percent abroad. In the mid-1980s (1985 to 1987) the United States experienced a dramatic decline of its national saving to an average of 2.1 percent of national income. Such a low rate of national saving is unprecedented for periods of economic expansion, not only for the United States but for all industrialized nations.

The decline in national saving has forced the United States to borrow massively from foreigners ($417 billion from 1985 to 1987) and to reduce net domestic investment by 2 percentage points relative to the 1970s, which included two recessions.[2] From 1985 to 1987, 60 percent of net national investment was financed by borrowing abroad.

Table I
Saving and Investment
(percent of national income)

| | 1985–1987 | 1970-1979 | Difference |
|---|---|---|---|
| Net National Saving | 2.1 | 7.9 | (5.8) |
| Equals: Net Domestic Investment | 5.7 | 7.6 | (1.9) |
| Plus: Net U.S. Investment Abroad | (3.6) | 0.3 | (3.9) |

---

[1] Strictly speaking, national income as usually defined differs slightly from net national product because of an adjustment for indirect taxes on business. This technical distinction is of no importance to our discussion and in what follows, we will use the concepts of national income and net national product interchangeably.

There is another measurement issue that we should note. Both national income and the saving rate are somewhat incorrectly measured because of failure to take account of the fact that part of government expenditure is actually investment. For this reason national saving is typically somewhat higher than measured, while national income is actually somewhat lower because of depreciation on government capital. However, the decline in national saving is almost certainly larger than measured because of cutbacks in government investment.

[2] A rate of national saving that is inadequate to support net domestic investment results in high real interest rates that depress the rate of capital formation.

Our continued dependence on foreigners to finance most of our net investment not only poses serious short-term risks, but undermines the prospects for growth of the U.S. standard of living. The low rate of net investment during the mid-1980s is inconsistent with sustained economic growth and international competitiveness. In fact, it has been argued[3] that a rate of net investment far greater, not less, than that of the past is needed for our country to compete and prosper over the remainder of the century.

Since national saving is the difference between income and consumption, the decline in the national saving rate is equivalent to a rise in the share of output that is consumed. Table II shows what happened in the 1985 to 1987 period as compared to the average between 1970 and 1979. The share of output consumed by the federal government, that is, government purchases, increased by only one percentage point.[4] Consumption by state and local governments remained unchanged. The problem of low national saving is therefore *primarily a problem of high personal consumption*.[5]

As discussed later, the escalation of personal consumption in the mid-1980s was primarily the result of four factors: large federal budget deficits, changing demographics, increases in personal wealth, and the financial restructuring of the corporate sector through debt-financed takeovers and leveraged buy outs. Before describing in more detail what caused the rise in personal consumption, however, we shall address the short-term risks and long-term damage to our economy that result from sustained low rates of national saving.

### *Short-run Risks of Low National Saving*

National saving can be used for two purposes: to invest in the growth of domestic capacity, or to accumulate net claims on foreigners, which will yield income in the future. The decline in U.S. national saving in the 1980s has been met primarily by a shift of the United States from a balance of payments surplus, in which we were gradually increasing our stock of overseas assets, to a balance of payments deficit, in which 60 percent of net investment in the United States is financed by borrowing abroad. America has also experienced a decline in the rate of domestic investment.

Some people have argued that the dependence of the United States on capital inflows is not a problem, but a sign of strength: it shows the willingness of foreigners to invest here. This argument tries to make a parallel between U.S. experience in the 1980s and our experience in the 19th century when large capital inflows helped to finance a high rate of investment. The parallel is, however, a false one. The United States has not been borrowing in order to invest. In fact, our investment rate is well below its level of the 1960s and 1970s, and the lowest in the industrial world. We are borrowing to consume.

What this means is that the United States is not repeating its own history, or emulating rapidly growing economies like South Korea that have borrowed heavily in order to finance high investment that leads to high productivity growth. Instead, we are following the example of the nations of Latin America, who borrowed heavily on world

Table II
Consumption and Net National Saving
(percent of national income)

| | 1985–1987 | 1970–1979 | Difference |
|---|---|---|---|
| National Income | 100.0 | 100.0 | - |
| Less: Personal Consumption | 74.1 | 69.3 | 4.8 |
| Less: Federal Government Purchases | 10.6 | 9.6 | 1.0 |
| Less: State & Local Government Purchases | 13.2 | 13.2 | - |
| Equals Net National Saving | 2.1 | 7.9 | (5.8) |

---

[3] G.N. Hatsopoulos, P.R. Krugman, L.H. Summers, "U.S. Competitiveness: Beyond the Trade Deficit," *SCIENCE*, 15 July 1988, Volume 241, pp. 299-307.

[4] The term government purchases means only direct spending by government, for example, purchases of supplies and compensation of government employees. These numbers do not include government transfers to individuals of which the Social Security program is the largest component. We have included government payments to foreigners with government purchases. The increase in government purchases between the 1970s and the mid-1980s was solely due to defense spending. In spite of these increases, federal purchases were a smaller share of national income for the 1985 to 1987 period than during the 1960s.

[5] Some have argued that the recent growth in consumption is partly due to higher outlays for durables which should in part be considered investment rather than consumption. Even consumption of nondurables and services as a share of national income increased by 4 percentage points between the 1970s and the mid-1980s.

markets but failed to use the foreign capital to expand their productive capacity.

What happened to the Latin nations was that it eventually became obvious that their dependence on foreign capital was unsustainable. When this happened, they experienced a loss of foreign confidence, and the capital inflows on which they had become dependent were suddenly cut off with devastating economic effects. At the moment the creditworthiness of the United States is still regarded as strong, because our foreign debt is still small compared to the size of our economy; but the risk of a loss of confidence and a cutoff of capital flows cannot be ruled out.

If such a cutoff of capital flows were to occur, the ensuing reduction in national income could be substantial. Most estimates suggest that capital inflows are currently allowing the U.S. economy to live 5 percent or more beyond its means.[6] That means that a cutoff of capital flows would force the United States to make a sudden adjustment comparable in size to that forced by the energy crises of 1973 and 1979 combined. The result could easily be a recession induced by the efforts of the Federal Reserve to control inflation, with an associated loss to the economy considerably greater than 5 percent.[7]

These risks do not seem pressing at the present time, but for a very unfortunate reason: The low value of the dollar makes the purchase of U.S. assets by foreigners very advantageous to them. As a result, net U.S. wealth is being transferred to foreigners. If this transfer continues for a prolonged period, the long-run consequences for the well-being of the American people will be onerous.

### *Long-run Consequences of Low National Saving*

Low national saving must eventually translate into low domestic investment. While it is possible to finance investment for a time through foreign borrowing, eventually the U.S. economy must pay its own way, which means that the ability to invest is constrained by the willingness to save. The problem is that investment is the single most important factor in determining the economy's rate of productivity growth. The United States already has the lowest rate of net investment and, not coincidentally, the lowest rate of long-term productivity growth (measured as the percentage change in real GDP per employed person, 1979 to 1986) among the major industrial countries. A squeeze on investment will further accelerate our relative decline.

This investment squeeze can be postponed for a time to the extent that the United States is able to attract inflows of foreign capital. However, these inflows carry their own cost: an increasing share of U.S. assets end up being foreign-owned, implying that in the future a growing share of U.S. output will be claimed by foreigners.

There is a tendency on the part of most Americans to regard the im[illegible] foreign ownership as marginal; we find it hard to ima[illegible]at an economy as large as that of the United States c[illegible] be in the process of seriously mortgaging its future. Yet the numbers do not support such complacency. The market value of all U.S. corporations, public and private, large and small, is only $2,400 billion; foreign claims on the United States are already more than $1,000 billion, and because of our dependence on foreign financing, net foreign claims are increasing at a rate of between $120 and $160 billion a year. Admittedly, most foreign investment in the United States is in interest-bearing assets, not corporate equities, and corporate assets are only one fifth of U.S. wealth. Nonetheless, foreigners could have a large stake in the U.S. economy, including control of a number of corporations, by early in the next century.[8]

Such a prospect might be viewed with equanimity if foreign investment in the United States were attracted by the strength of our economy and were helping to finance a high rate of investment. But this is not the case. We are in effect selling U.S. assets to pay for consumption, not to finance creation of productive capacity. And since 1985, we have been able to attract foreign capital only by making U.S. assets progressively cheaper in terms of foreign currencies, through a continually depreciating dollar.

The need to attract foreign financing by depreciating the dollar, of course, adds to the eventual cost of our dependence on foreign funds. *To a certain extent the U.S. is not only mortgaging its future through foreign borrowing, but holding a "fire sale" of its assets at bargain prices in order to raise funds.*

It is important to emphasize that there is nothing wrong per se with foreigners buying U.S. assets. If Americans were to buy foreign assets of the same long-term value as those foreigners bought in the United States, the transaction could be beneficial to both. This would happen if the U.S. current account were balanced and if the exchange rate of the dollar were at its long-term equilibrium rate. The problem with the current situation is that the United States is selling its assets to finance consumption and quite possibly doing so at too low a price.[9]

---

[6] The 5 percent number may seem surprising, given that the current account deficit is only approximately 3 percent of gross national product. The larger number results from observation of two main points. First, net national product is somewhat smaller than GNP, so the ratio of the current deficit to this number is larger. Much more important, in order to bring its trade quickly into balance, the United States would have to depreciate the dollar sharply. This dollar depreciation would drive up the price of imports, reducing U.S. real income and requiring a larger contraction in real spending.

[7] The recent growth in corporate leverage which we discuss in more detail in Appendix II, could magnify the effects of a cutoff of foreign capital. Highly leveraged firms are particularly vulnerable during periods of recession and high interest rates.

[8] Net foreign investment in the United States between 1985 and 1987 was $417 billion. Of that 76.5 percent was invested in financial assets other than direct investment, 18.2 percent was used to acquire U.S. corporations and divisions of U.S. corporations, and 5.3 percent for other direct investments. Acquisitions of U.S. companies by foreigners have constituted an increasing fraction of net foreign investment: 9.5 percent in 1985, 17.2 percent in 1986, and 25 percent in 1987. Other direct investment as a share of net foreign investment has been declining. (Source: *Flow of Funds Accounts*, Board of Governors of the Federal Reserve System and *Mergerstat Review*, W.T. Grimm and Company.)

The problem of U.S. dependence on foreign capital cannot be solved by treating symptoms – by trying a crash program of reducing the trade deficit by forcing the dollar down even further, or by trying to support the value of the dollar in order to avoid a "fire sale." If the U.S. were somehow to eliminate its current account deficit without raising the national saving rate, we would be in even worse trouble because the inadequacy of domestic saving would force a severe squeeze on investment. On the other hand, if the U.S. were somehow to raise the value of the dollar, the result would be to further widen our current account deficit. The only way to avoid a "fire sale" of our assets is not to need one.

The above discussion leads to one conclusion: *It is a national imperative to increase national saving immediately.* Such action is necessary both to reduce short-term risks and, more importantly, to prevent long-term damage to America's economic future.

### *The Rise of Personal Consumption*

The unprecedented escalation of personal consumption in the mid-1980s is a recent phenomenon – personal consumption as a percent of national income exceeded previous historical peaks in each of the years after 1981. This escalation has been attributed to many causes including the presence of large federal deficits during a long economic expansion, changes in demographics, the rise in personal wealth, and the changing attitudes of people.

The determinants of consumption are a source of intense debate among economists. Much thinking on the subject assumes that individual households rationally formulate lifetime consumption plans based on both their current wealth and their expected earnings. If this were a good description of actual behavior, consumption spending would be unresponsive to many influences commonly cited. For example, dividend payments and accrued but unrealized capital gains would have equal effects on consumption. In addition, tax cuts would not be spent, because households would foresee the eventual burden of servicing government debt.

For a number of reasons, however, this stylized view is an inadequate description of actual consumption behavior. The most common objection is that many households, especially low income households, may face liquidity constraints because they are unable to borrow against future labor income. Such constraints force households into a shorter-term focus, in which changes in cash flow, whether due to reduced taxes or higher pre-tax income, may raise consumption more than their impact on lifetime earnings would indicate. Even higher income households who hold substantial assets and do not face liquidity constraints may, however, be excessively sensitive to current cash flow. They may base their spending on rules of thumb that give a high weight to current receipts. For example, sophisticated managers have a tendency to ratchet up their consumption in response to a high bonus during a year of record earnings, although they are fully aware of the temporary nature of such a payment. Because of this, many large corporations accrue bonuses and pay them over a number of years.

There is substantial empirical evidence that households associate consumption more with current cash flow than with unrealized capital gains. This was one reason that corporations paid cash dividends prior to the Tax Reform Act of 1986, even though under pre-1986 tax rules they could have reduced stockholder taxes by issuing stock dividends and transferring cash to stockholders through share repurchases. Thermo Electron and other high technology companies did make use of stock dividends; but this led to criticism from many stockholders who would have preferred to receive cash dividends because they were unwilling to sell shares to support current consumption.

The evident inadequacy of a framework in which households form fully rational lifetime consumption plans has led most econometric model-builders to adopt a specification for the aggregate consumption function in which both household net worth and current disposable income affect spending decisions. Our empirical research, summarized in Appendix I, extends the usual approach to estimating aggregate consumption functions by examining the effect of forced conversions of corporate equities into cash.[10] Such conversions have resulted from the extraordinary level of activity in debt-financed takeovers and leveraged buy outs in the mid-1980s. Figure I illustrates the magnitude and the unusual aspect of these activities. Prior to 1984 net new equity issues in the corporate sector were very small, averaging about zero. Since 1984, net new equity issues have been negative – equity retirements have exceeded new equity issues by large amounts. Concurrently, net additions to debt have grown rapidly.

---

[9] There is considerable debate over whether the dollar is currently under- or over-valued relative to the level it will settle at in the long run. Nothing crucial in our argument depends on which side is right. At the moment financial markets believe that the dollar is weak enough to ensure a steady decline in the U.S. current account deficit. If they are right, then capital inflows, which are by definition equal to the current deficit, will also steadily decline, implying a growing squeeze on U.S. investment. If the current deficit does not continue its decline, markets will without doubt force the dollar still lower until it reaches a level at which the external deficit really does come down. Either way, within a few years, the U.S. will be forced to do without the massive net capital inflows that have replaced our vanishing national saving up to this point.

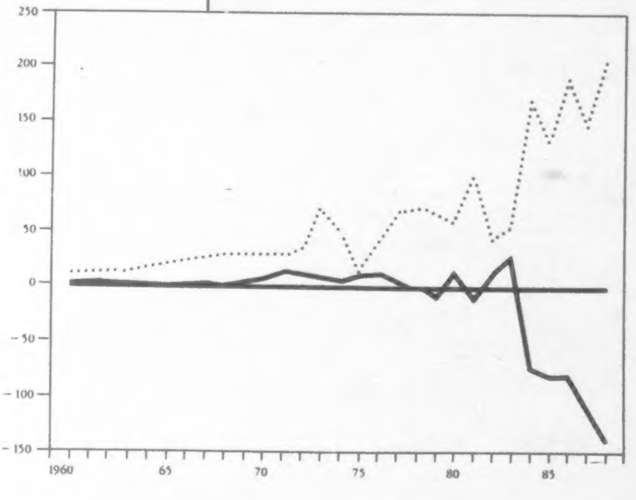
[10] One would of course expect a correlation between *voluntary* realization of gains and consumption spending, since households may realize gains to finance spending on durables or large nondurable purchases. Our analysis focuses on the spending effects of involuntary realizations.

Debt-financed purchases of corporate stock force stockholders to convert their equity holdings, at least temporarily, into cash. This would not affect the fully rational investors of the stylized view. They should view cash and stocks as affecting their wealth equally and should immediately reinvest any cash accruing from a sale of stock. In reality, however, this is not the case: cash receipts are more likely to induce current consumption than gains that have not been converted into cash. This observation is consistent with previous empirical work and the results described in Appendix I, according to which persons consume only about 3 cents of each dollar of increased net worth as contrasted to over 50 cents on each dollar of forced conversions of equity to cash.

Our study of the underlying determinants of consumer spending sheds new light on the growth in consumption during the 1980s. *Our findings summarized in Table III and explained in more detail in Appendix I suggest that the rising ratio of consumption to national income can be explained largely as a result of four factors: growth in disposable income, changing demographics, variation of household wealth, and forced conversions of equity into cash.* In the 1985 to 1987 period, the consumption share of national income was 4.7 percent greater than in the 1970 to 1979 period. While the imprecision of econometric estimates suggests that our findings be viewed as illustrative rather than as a precise decomposition, our basic results suggest that the growth in disposable income, due primarily to rapid increases in interest income, accounts for 1.8 percentage points (more than one third) of this increase. The decline in the share of the population under age sixteen, with its associated changes in spending behavior, may explain one quarter of the consumption growth. Rising household wealth and forced equity-to-cash conversions each account for approximately one-sixth of the increase in consumption as a share of national income. There remains a small unexplained growth component.

The rise of disposable income as a percent of national income in the mid-1980s relative to the 1970s, to which we attribute more than a third of the increase in consumption, is essentially the result of the change in only one component: personal interest income. Labor income, the largest component of disposable income, declined slightly. Transfer payments less personal taxes and contributions for social insurance remained virtually constant.

**Figure 1**
Nonfinancial Corporate Sector
($ in billions)



The rise in interest income resulted primarily from the high real interest rates in the mid-1980s. Real interest rates[11] received by households averaged 6 percent in the 1985 to 1987 period as compared to 1.5 percent in the 1970s. Real interest rates were much higher in the mid-1980s than in the past partly[12] because national saving was insufficient to fund domestic investment. The link between saving and interest rates implies that an autonomous decline in saving, say due to demographic factors, may be magnified through its effect on interest rates. This multiplier effect also worsens the federal deficit by increasing the interest paid by the federal government.

The rise of personal wealth in the mid-1980s, to which we attribute a part of the rise in consumption, is partly due to the rise in the stock market which in the 1980s more closely reflects the replacement cost of corporate net worth than it did in the 1970s. The rise of personal wealth is also related to the increase in the federal deficit. National net worth is all that Americans own. The apparent net worth of households equals the national net worth plus the federal debt. The large deficits of the 1980s caused national debt to grow faster than national net worth and, as a result, personal wealth grew faster than national net worth.

The contribution of debt-financed takeovers and leveraged buy outs to the decline of national saving is not limited to their direct effect on consumption discussed earlier. Forced conversions of equity into debt affect national saving in two additional ways. First the shift from equity to debt reduces federal revenues since interest payments may be deducted from the corporate tax burden while retained earnings or dividends may not.[13] Second, when corporations shift from equity to debt, they ordinarily end up paying more in interest than they would have paid in dividends and have less retained earnings. Thus personal disposable income rises at the expense of accrued capital gains. Since the propensity to consume is much higher for changes in disposable income than for accrued capital gains, such a shift promotes consumption.

Aside from demographic change, then, the rising share of private consumption in the 1980s may be attributed to a rise in interest income, an increase in private wealth that exceeded the growth in national wealth, and the direct impact of conversion of corporate equity to debt. These factors were not exogenous, however. For example, the rise in interest income was driven by the combination of budget deficits and conversions of equity to debt, and corporate decapitalization was largely due to changes in the tax laws.

### *A Strategy to Raise National Saving*

It is imperative that we increase national saving immediately. This means, by definition, reducing consumption's share of net output. ***The ultimate goal should be to bring national saving from about 2 percent of net output in the mid-1980s, to above the 1970 to 1979 average of about 8 percent of net output.*** The increase, however, should not be done too rapidly. Otherwise, we would risk taking the economy into a recession caused by insufficient demand. Such a recession would tend to lengthen the period of adjustment. Rather, we want to substitute for the decrease in domestic consumption a comparable increase in net exports and net investment.

**Table III**
Sources of Consumption
Growth 1985 to 1987
versus 1970 to 1979

| | Estimated Consumption Effect (% of NNP) |
|---|---|
| Disposables Income/NNP | +1.8 |
| Percentage of Population less than 16 years old | +1.0 |
| Net Worth/NNP | +0.8 |
| After-Tax Cash from Takeovers/NNP | +0.7 |
| Total Explained Change | +4.3 |
| Unexplained Change | +0.4 |

---

[11] Real interest rates were calculated by subtracting from nominal interest rates the annual percent change of the personal consumption deflator. Nominal interest rates were calculated as the ratio of personal interest income divided by deposits and credit market instruments owned by households. (Source: *Balance Sheets of the U.S. Economy*, Board of Governors of the Federal Reserve System, and *National Income and Product Accounts of the United States*, U.S. Department of Commerce.)

[12] Financial deregulation and the proliferation of high-risk, high-yield securities to finance mergers and leveraged buyouts also contributed to the high real interest rates received by households.

[13] The net effect of LBOs on federal tax receipts is somewhat controversial. The forced realization of capital gains and the increased rate of corporate profits associated with these transactions may increase tax receipts, partly offsetting revenue losses from increased interest deductions.

There are two ways to increase exports. The first is to reduce the exchange rate of the dollar and the second is to improve the productivity of U.S. manufacturing and the quality and distribution of the products it makes. The first way is costly – it makes U.S. assets cheaper and imports more expensive. The second way is more lasting and in the long run more beneficial.

To make U.S. manufacturing inherently more competitive will require increases in the rate of investment not only in tangible assets, but also in research, development, and marketing. Accordingly, *a strategy focused primarily on an increased rate of investment to substitute for decreased consumption not only helps avoid a recession but also helps solve our long-term problems.*

The rate of investment in industry depends strongly on industry's cost of capital. The cost of capital is a composite of the cost of debt and the cost of equity. The cost of equity, which is particularly important for long-term investments, has always been higher than the cost of debt partly because interest payments on debt are excluded from taxation whereas dividends and retained earnings are not. As discussed later, changes in the tax code during the 1980s have widened the difference between the two costs and have been instrumental in encouraging conversions from equity to debt in the corporate sector. What is needed to improve the competitiveness of our industry is both a lowering of the overall cost of capital and a reduction of the gap between the cost of equity and the cost of debt.

An increase in our national saving rate will, of course, reduce interest rates. This reduction, however, may not be sufficient to achieve the required level of investment. Other initiatives, such as changes in the tax code, may also be required.

Doing all of these right things does not guarantee that we can avoid either overheating the economy or slowing down the rate of output growth. We simply do not possess the skills, let alone the determination, to "fine-tune" the economy that well. Nevertheless, we have to try – delaying only makes things worse.

*There are three ways to increase national saving: (1) Reduce the federal deficit, (2) induce voluntary increases in personal saving, and (3) slow down the escalating leveraging of U.S. business.* Each of these ways will be discussed in more detail.

### *Reducing the Federal Deficit*

The emergence of a large federal deficit in the 1980s is a significant contributor to the decline in national saving. The popular view, however, that the deficit is the sole villain does not stand up to analysis. First, as seen in Table IV, the decline in private saving is more important than the increase in the federal deficit in explaining the reduction in national saving. Second, there is less than one-to-one correspondence between changes in the budget deficit and national saving.

Table V shows the major components of federal income and spending in the period 1970 to 1979, contrasted with 1985 to 1987. Direct purchases increased mostly as a result of increased defense spending. Increases in transfer payments were quite sizable. Net domestic interest increased partly because of the accumulation of deficits in the 1980s and partly because real interest rates are higher now than in the past.

This last point implies not only that we are now paying for past sins but also that the budget deficit is affected by the level of interest rates which, in turn, is affected by the level of national saving. Thus, an improvement in national saving can, per se, improve the federal deficit.

As a matter of accounting, national saving is the sum of government saving (the budget balance) and saving by the private sector. This might lead one to conclude that changes in the budget deficit should be reflected one-for-one in changes in the national saving rate. This is not, however, the case, because policies that change the budget de-

Table IV
Composition of Net National Saving
(Percent of national income)

| | 1985–1987 | 1970–1979 | Difference |
|---|---|---|---|
| Private Saving | 5.5 | 8.9 | (3.4) |
| Plus federal government saving | (4.9) | (1.9) | (3.0) |
| Plus state and local government saving | 1.5 | 0.9 | 0.6 |
| Equals national saving | 2.1 | 7.9 | (5.8) |

ficit may also affect private saving, often in ways that undermine the effect on national saving.

Two extreme examples may make the point. On one side, consider a reduction in the deficit achieved by reducing government consumption. Since this directly reduces consumption, we may expect it to be more or less fully reflected in higher saving.[14] On the other side, suppose the government were to reduce its deficit with a higher tax on investment income. This would increase government saving; but by reducing the private incentive to save, it would reduce private saving, so that the overall effect on national saving would be far less than the reduction in the federal deficit (and could even be negative, if private saving were especially sensitive to investor returns).

Other measures will usually lie between these extremes. A reduction in government transfer payments will typically affect individuals who have a high propensity to consume, and thus will induce a strong response in national saving. A tax increase will be less effective, since many households may choose to save less rather than consume less, at least at first.

The important points are: i.) reducing the federal deficit may not lead to a corresponding increase in national saving; ~~and,~~ ii.) the way in which the deficit is reduced matters – not all deficit reduction measures have the same effect on national saving.

At the present time the focus of federal deficit reduction efforts is on the narrowly defined accounting balance, with a timetable for deficit reduction set by Gramm-Rudman-Hollings. This narrow focus has some unfortunate consequences, leading to an emphasis on measures that narrow the deficit without any regard for their effect on the national saving rate – which is the true bottom line.[15]

Nonetheless, now is not the time to do away with targets for the budget deficit, even if these targets sometimes distort policy. Recent political experience has shown that setting rigid targets is, for the time being, a vitally necessary discipline on the political process. What we need to do is maintain the targets for deficit reduction, while placing them in the context of a broader policy aimed at raising national saving. *Deficit reduction alone will not cure the saving problem, especially if it is focused only on short-term accounting goals, but it remains a key part of an overall program.*

### *Inducing Voluntary Increases in Personal Saving*

The ability of government to induce greater voluntary saving has been badly underestimated by policymakers. The reason is the strong conviction of some leading economists that incentives to save don't work. This conviction stems from absence of a definitive statistical association between personal saving and after-tax returns on personal saving accounts over many decades.

The absence of such statistical association is understandable. As discussed previously, returns on investments have different effects on consumption and saving depending on whether the return consists of accrued unrealized appreciation, or it is paid in cash. It is quite possible that increases in real interest rates on credit market instruments encourage consumption whereas investment opportunities for high real rates of appreciation encourage saving.

**Table V**
Federal Spending and Revenue 1970–1987
(As percent of net national product)

*Payments to foreigners were included with direct purchases for consistency with Table II.

| | 1985–1987 | 1970–1979 | Difference |
|---|---|---|---|
| Direct Purchases and payments to foreigners* | 10.6 | 9.6 | 1.0 |
| Plus transfers to persons | 10.1 | 8.5 | 1.6 |
| Plus net domestic interest | 3.0 | 1.3 | 1.7 |
| Plus intergovernmental grants and other | 3.4 | 3.8 | (0.4) |
| Total outlays | 27.1 | 23.2 | 3.9 |
| Less revenue | 22.2 | 21.3 | 0.9 |
| Equals deficit | 4.9 | 1.9 | 3.0 |

---

[14] Reductions in government investment could discourage private saving by lowering the return to private investments although we suspect this effect is small. Some economists have argued that even a cut in government consumption will not increase national saving, since the private sector will see that this cut reduces the need for future tax increases and therefore consume more today. This argument presupposes a degree of knowledge and sophistication on the part of the average household that we believe few if any consumers possess in practice.

[15] One way to emphasize the importance of focusing on the true bottom line is to notice that a dollar of additional private savings is worth more to the economy than a dollar of deficit reduction because most measures that reduce the deficit will be at least partially offset by reduced private savings.

Many countries, including the United States, have experimented with saving incentives. Opinion in the United States has been soured by the failure of the availability of IRAs to prevent the decline in saving in the 1980s. Yet the pessimism about incentives is not warranted by a more careful look.

This is not the place for an extended survey of evidence on saving incentives. We will simply note two points. First is that Canada has a program of saving incentives in place and that in the 1980s Canada has not shared in the precipitous U.S. saving decline. This observation, together with some more formal econometric evidence, suggests that the program has indeed had a positive effect on saving. (A more detailed discussion of the evidence may be found in Appendix III).

Second, we note that the IRA as a saving incentive had some severe limitations. On one side, the amount of sheltered income was limited so that no incentive was provided at the margin for individuals who would be saving heavily anyway. On the other hand, because the incentive was tax-based, it was most valuable to individuals with high income, who were most likely to be saving a good deal in any case. Furthermore, the setup of the IRA encouraged last-minute financial reshuffling rather than a precommitment to save more over time.

In spite of this, some studies suggest that IRAs actually had a positive effect on U.S. saving, i.e., that the saving rate fell in spite of rather than because of IRAs. A better-conceived scheme should therefore have a good chance of success.

The example of Japan is instructive. Before World War II the Japanese people saved less than the Americans. Japan's enormous rate of personal saving after the war was not merely attributal to cultural differences. It was the result of a national campaign. Not only were incentives provided, but more significantly, monthly seminars on the importance of workers' saving were conducted in most major corporations and publicized in the media. Moreover, no Japanese leader was promoting consumption as is frequently done by leaders in the United States.

Public promotions do work in America – from the campaign on careful driving that started after World War II to the promotion of energy conservation that started in the mid-1970's. America now has a lower rate of automobile fatalities than any other country in the world, and our energy consumption in 1987 was the same as in 1973, even though the economy's output increased in real terms by more than 50 percent. On this latter point, many attribute the increase in U.S. energy productivity solely to higher prices. This is not quite so. There is ample evidence that prior to the 1976 campaigns on energy conservation, prior to the Coalition to Save Energy, and before the appointment of energy "czars" by corporations, few individuals or corporations made energy saving investments with paybacks greater than one year. After the campaign, however, many investments were made with paybacks of over 4 years. Americans should know better than anyone that to sell an idea, even one that has value, requires promotion.

The kind of saving initiative that might be effective for the United States should emphasize several features. First, the incentive should be valuable to households regardless of tax bracket. Second, it should induce a regular pattern of saving, rather than solely encourage portfolio reshuffling. Third, the initiative should come as part of a public campaign on behalf of higher saving. Finally, the size of the incentive should be adjusted to achieve a cost effective increase in national saving.

A kind of proposal that might work is described below. *The federal government would expand the current savings bond program to issue higher yield zero-coupon "supersavings" bonds*, which would be non-negotiable and redeemable at face value after 7 years. These bonds could be marketed through banks and other financial institutions to fulltime corporate employees who can purchase them only through monthly payroll deductions, up to $5,000 per worker annually. The bonds would be either redeemed at maturity, at which time any gain would be fully taxed, or they would be rolled over. *The new bonds should be introduced with some fanfare, and the government should lobby businesses to promote the bonds actively among their employees. We view the campaign to raise saving as being at least as important as the actual saving instrument; active promotion is important.* Business experience suggests that participation of employees in benefits such as stock purchase plans or 401k plans increases dramatically after company-sponsored seminars and other promotional activities.

Such a plan would, of course, impose some budgetary cost in the long run because the government would, in effect, be borrowing funds at above-market rates. Although such a cost may turn out to be very small compared to the benefit to the nation, nevertheless, the government should adhere to the discipline of Gramm-Rudman-Hollings and find a way to offset any revenue lost.

### *Slowing Down the Leveraging of U.S. Corporations*

The ongoing shift from equity to debt in the corporate sector has probably been an important cause of low national saving in the 1980s. It has also created an unnecessary source of economic vulnerability by creating highly leveraged firms that would be placed at risk by any economic downturn or rise in interest rates. Thus, it is desirable to find a way of discouraging the growth of debt that we have recently seen.

There are probably many reasons for the shift from equity to debt that is taking place during the 1980s. The most obvious of these is that tax incentives for corporate borrowing have significantly increased during the last decade. The relative tax burden on debt as compared to equity depends on both corporate and investor taxes. The general trend toward reductions in individual tax rates – from a maximum of 70 percent in 1980 to 28 percent today – has reduced the net tax burden on interest payments and made corporate borrowing more attractive than in the past.

To illustrate the effect of the changes in tax burdens on equity and debt that took place between 1980 and 1987, an example is presented in Appendix II which compares the returns a top-bracket corporate investor would receive per dollar of pretax corporate profit from a corporation totally equity-financed to those from a corporation totally debt-financed for the years 1980 and 1987. The results are shown in Table VI.

*It is evident that in 1980 the tax code favored equity over debt. In 1987, however, debt is much more favored than is equity.* The changes in the tax code during the 1980s in favor of debt will certainly increase the debt-to-equity ratio of U.S. corporations relative to past experience.

Proposals to regulate takeovers and leveraged buy outs directly are inadvisable – interference with the free market usually does more harm than good. Instead, we believe that the right approach is to remove one of the main incentives for the increasing reliance on debt, the differential tax treatment of debt and equity. Interest on debt is deductible by corporations; payments to stockholders, or retained earnings, are not. This distinction causes increasingly important distortions in the economy. In addition to promoting consumption and reducing federal revenues, tax incentives for debt encourage investments with quick returns. In practice debt cannot be used to finance a long-term research and development project – only equity can. We have already discussed the need to lower the cost of capital and, in particular, the cost of equity to meet both our short-term and our long-term national objectives.

Table VI
Returns to Top-bracket Corporate Investors
(Percent of pretax corporate profit)

Firm A is representative of many corporations in the aftermath of a leveraged buy out. Firm B is representative of many firms in the high technology sector.

| | 1980 | 1987 |
|---|---|---|
| Corporation A: All Debt | 30 | 72 |
| Corporation B: No debt, no dividends | 39 | 48 |
| Difference B less A | 9 | (24) |

Ideally, we would want to lower the cost of equity to that of debt without affecting the latter. That, however, would be too costly to the federal government and, therefore, we have to find other ways to bring these two costs in line. One policy which eliminates all distortion between debt and equity finance is the expenditure or cash flow tax, advocated in recent years by the Meade Commission in the United Kingdom (1978) and in the Treasury Department's 1977 report, *Blueprints for Basic Tax Reform*. The expenditure tax would constitute a radical redefinition of the tax base: rather than taxing households on the basis of current income, they would be taxed on current expenditure.

A second set of proposals calls for either a partial or complete integration of corporate and personal income taxes. Integration allows shareholders a tax credit against personal income tax based on corporate tax payments. It eliminates (or with partial integration, reduces) the double tax burden on corporate earnings. It also reduces the cost of capital by eliminating one layer of taxation between the corporation and its investors. Such plans are practiced to different degrees in Great Britain, France, and most other European countries. Japan has also achieved parity between the cost of equity and the cost of debt by providing zero taxes on capital gains from equities and a high tax rate, up to 70 percent, on interest received.[16]

A third set of plans involves actions designed to alter the tax deductibility of some or all corporate borrowing. The most common proposals call for eliminating or restricting the deductibility of corporate interest payments, particularly if the interest payments result from a corporate control transaction (a merger or LBO). These plans equalize the costs of debt and equity by raising the former. The resulting increase in the cost of capital facing U.S. corporations would discourage investment and provide a competitive advantage to foreign firms which are still able to deduct interest payments.

A variation of such a proposal has been developed by the American Law Institute.[17] It calls for the disallowance of tax deductions on debt issues that have the effect of reducing equity. Although The American Law Institute's proposal does not discourage new investments, it does involve regulation and does not address the problem of foreign firms having a large advantage over American firms in buying U.S. corporations.

The simplest proposal is that of eliminating the tax deductibility of interest payments, and offsetting this with a reduction in the corporate tax rate that leaves actual taxes unchanged for the average firm. The main problem with this proposal is that it would actually benefit owners of existing capital, while raising the cost of new capital to firms. Thus it would provide a windfall to firms that are not investing much, while penalizing those that invest heavily – the reverse of what we would like to do. Not incidentally, this would repeat the error of the 1986 tax reform, which eliminated accelerated depreciation while reducing corporate taxes.

---

[16] Prior to the 1989 Japanese tax reform, the tax code in Japan favored equity over debt more than the United States did prior to 1980. This fact seems inconsistent with the high leverage of Japanese corporations. Japanese corporations, however, started at the end of World War II with practically no capital and the Bank of Japan provided them funds through the banking system. As the equity markets developed, corporate leverage has been rapidly declining.

[17] See American Law Institute, Federal Income Tax Project, Tax Advisory Group Draft No. 18 (Nov. 1988)

The reason for this effect may be stated briefly: under existing law, the rate of depreciation allowed for tax purposes is somewhat faster in real terms than the actual economic rate. This is true even of physical investment in capital. It is especially true of investment in "invisible" assets such as R&D, which can be expensed. As a result, a unit of newly created capital has an advantage over an otherwise equivalent unit created some years earlier. A reduction in the tax rate reduces this advantage.

Appendix IV examines this point numerically. It suggests that under realistic assumptions about inflation and depreciation, a combined elimination of interest deductions and tax cuts, even if revenue neutral, would have a significant effect in raising the cost of capital for corporate investment. In addition, such an adjustment would result in a corporate tax rate of less than 22 percent, well below the maximum personal tax rate of 28 percent. Lowering of the corporate tax rate below the personal tax rate creates many problems, inducing persons to incorporate many of their personal activities.

### *A Possible Alternative*

In what follows we describe a relatively simple method that reduces the cost of equity and raises the cost of debt without affecting the cost of capital or federal revenues. The proposed change would replace the current deduction of interest on debt with a general deduction for capital, set at some percentage of the over-all capitalization of a company, however financed. At current debt to equity ratios and interest rates, a cost-of-capital deduction equal to 5 percent of capital would be approximately revenue-neutral. Such a scheme would leave intact the present favoring of new investment over existing capital and thus avoid a windfall to old capital. At the same time, it would remove the tax incentive for increasing debt. In implementing such a proposal, carefully crafted transition rules should be established to allow corporations with large debt obligations ample time to replace their debt with equity capital.[18] We do not foresee any insurmountable problems.

A central element of this proposal is the definition of total capitalization. For nonfinancial corporations, it is the sum of recorded shareholders' equity plus the average of any loans for which the interest rate paid is greater than the deducted rate, e.g. 5 percent.[19] For financial corporations only equity should be counted as capitalization, but these corporations should be allowed to offset interest expense against interest income as long as their net interest income is positive.

Some may point out that a standard deduction based on total capitalization is arbitrary. It is, but so is a deduction for the cost of debt and not for the cost of equity. To allow an equal deduction for both equity and debt is fairer than what we now have and more conducive to economic growth.

### *Conclusion*

*The fundamental problem of the U.S. economy in the 1980s is not the budget deficit but overconsumption.* This overconsumption is being financed through large-scale sales of U.S. assets to foreigners at unfavorable terms, a process that postpones the day of reckoning but that increasingly mortgages the U.S. economic future.

Overconsumption is fed partly by the budget deficit, but also by other sources. In particular, there is good reason to believe that the collapse of national saving and the explosion of corporate debt in the 1980s are closely related. The increased leveraging of corporations has raised interest income, led to large realizations of capital gains that get translated in part into consumption, and contributed to the budget deficit.

Because overconsumption in the United States is not simply a by-product of the budget deficit, it needs to be addressed on several fronts. Modest progress on the budget deficit will not be enough: ***we need a concerted program aimed at raising national saving from its unprecedentedly low level.*** ■

---

[18] For example, corporations can elect to continue deducting interest expenses on any long-term debt acquired prior to enactment and on any short-term debt up to the amount present at enactment. As long as they make use of such an election, no deduction on equity will be provided. Detailed transition rules are beyond the scope of this paper.

[19] This is necessary to prevent corporations from defining as debt other liabilities such as accounts receivable. The rate of credit for capital could be varied in line with Treasury bill yields or other measures of market required returns.

# Appendix I:

## Determinants of Consumer Spending

The determination of consumer spending is a fundamental yet controversial issue. Standard economic theory argues that absent credit market imperfections or consumer myopia, consumption would depend only on household net worth. This is the sum of the present value of current and expected future labor earnings, plus current net holdings of real and financial assets. In this setting, neither the cash income from investments nor the flow of after-tax wages would affect spending unless it affected household net worth.

A variety of considerations, however, make this stylized view an inadequate description of actual consumption behavior.[20] First, many households, especially lower income households, may face constraints that make it difficult to borrow against future labor income. If these households would like to borrow and consume more than their current income, liquidity constraints may restrict consumption to current after-tax income. Increases in cash flow, whether due to reduced taxes or higher wages, therefore raise consumption. Second, even high income households with substantial asset holdings may over-react to fluctuations in current income, failing to distribute a current windfall over current and future consumption. This is particularly relevant for our analysis of forced capital gain realizations.

These considerations among others have led most econometric model-builders to adopt a specification for the aggregate consumption function in which both household net worth and a measure of current cash income – typically disposable income as reported in the National Income Accounts – affect spending decisions.

This specification is usually applied to per capita consumption (denoted C) as

$$C = a_0 + a_1 YD + a_2 W$$

where YD and W, respectively, measure per-capita disposable income and net worth. This equation makes clear that changes in the economic environment that raise YD, either by lowering taxes, raising real interest receipts, or increasing labor income, raise consumption. So do increases in household net worth.

Our analysis extends the usual approach by including after-tax cash receipts from forced capital gain realizations in corporate takeovers as an additional explanatory variable in the consumption model. We do not constrain it to have the same coefficient as disposable income. We also follow many previous studies in adding simple measures of the population age structure to our equation, reflecting the possibility that the aging of the U.S. population has raised aggregate spending for reasons unrelated to wealth or income.[21]

This appendix is divided into two parts. The first presents our estimates of the aggregate consumption function. In the second part, we use these estimates to evaluate the relative importance of a variety of factors in contributing to the rise in consumption between the 1970s and the mid-1980s. We show that the growth in personal income as a share of NNP accounts for nearly 40 percent of the increase in real consumption. Demographic factors can explain another quarter of the consumption growth. Increased household wealth and the growth in cash receipts from corporate takeovers also have positive effects on consumption, each accounting for about one-sixth of the consumption increase.

### *Consumption Function Estimates*

Our primary concern is explaining changes through time in the ratio of consumption to national income, so we use this ratio as the dependent variable in our estimated consumption function. We follow common practice in using the measure of disposable income reported in the National Income and Product Accounts, along with the Federal Reserve Board's estimate of household net worth, as explanatory variables. We add two variables to this list, the share of the population under age 16 and the value of after-tax cash payout in mergers.

The population share under age 16 is drawn from Census reports. We choose this measure of demographic shift for two reasons. First, much of the popular discussion of why saving has declined has emphasized the aging of the "baby boom" generation. Since consumption outlays by adults exceed those of children, consumption as a share of national income should be lower when the share of children in the population is higher. The share of the population under age 16 declines from 34.1 percent in 1960 to 24.5 percent in 1987. Second, when we tried including more detailed demographic variables (for example a set of variables measuring the fraction of the population in each ten-year age group) we obtained very imprecise estimates. This simply reflects the limited amount of time-series data available for our study.

We constructed a measure of the household sector's after-tax cash receipts in merger transactions. W.T. Grimm and Company has tabulated the number and value of merger transactions since 1968.[22] Not all takeovers, however, provide cash to stockholders of the target firm. If the takeover involves an exchange of securities, shareholders receive shares (or debt) in the acquirer in return for their shares in the target. Only cash takeovers generate after-tax cash flow for investors. Unfortunately W.T. Grimm does not report the amount of acquisition activity by financing method. It does, however, report the number of cash mergers as well as the number of other types. To construct a proxy for the value of cash payouts in corporate control transactions, we multiplied the total value of takeovers in each year by the share of transactions involving cash payments. Provided the average size of cash and non-cash mergers is not very different, our data-series should provide a reasonable guide to the time-series movements in cash payout.[23] For the years 1950 to 1967, we extrapolated the Grimm data-series using information from the Federal Trade Commission on the value of large mergers in mining and manufacturing.[24]

---

[20] Further discussion of the "corporate veil" may be found in James M. Poterba, "Tax Policy and Corporate Saving," *Brookings Papers on Economic Activity 1987:2*.

[21] A detailed examination of demographic influences on consumption may be found in M. Boskin and L. Lau, "An Analysis of Postwar U.S. Consumption and Saving: Parts I and II," NBER Working Papers 2605 and 2606, Cambridge, MA, 1988.

[22] These data are presented each year in the *Mergerstat Review*.

We conjecture that households' after-tax cash receipts from corporate control transactions may affect consumption. These receipts are smaller than total cash payments for two reasons: households do not own all corporate equity, and they are liable for taxes on the cash they receive. Since there is no direct information on the ownership of firms involved in corporate control contests, we assume that the household share in these firms equals their share of domestically-held corporate equity. Data on equity ownership are reported annually in the Flow of Funds *Balance Sheets of the U.S. Economy.*[25] We estimate the tax liability associated with these transactions in a crude manner, assuming that the stockholder's basis in his shares is half the sale price. We also assume that the gains are taxed at the maximum statutory capital gains rate, so the tax liability equals:

Capital gains taxes on cash merger payout = $t_{cg}$ x (.5) x (household equity share) x (cash takeovers).

Using these data, we define after-tax cash receipt series as:

$(1-.5\,t_{cg})$ x (household share of equities) x (cash takeovers).

This is the variable included in our regression equation. The data series is shown in Table VII, measured both in current dollars and constant (1982) dollars and as a fraction of net national product.

Our focus on the consumption effects of cash receipts from takeovers suggests a minor modification to the National Income Accounts disposable income measure. Disposable income equals personal income less taxes. Some of these taxes result from the realization of capital gains in control transactions, and therefore reduce disposable income, even though capital gains themselves are not included in personal or disposable income. When capital gain realizations are high, other things equal, disposable income will be low. We correct for this spurious negative link between realizations and disposable income by defining:

Augmented = NIPA Disposable Income
Disposable + Capital Gains Taxes
Income on Cash Merger Payout

We estimate the basic consumption relationship using annual time-series data for the 1950 to 1987 period. Our central regression result, which corrects for serially correlated errors in the consumption function using autoregressive least squares, is shown below:[26]

C/NNP =
.28 x (1/Real Per Capita NNP)
(.10)

+ .83 x (Augmented Disposable Income/NNP)
(.03)

+ .59 x (After-Tax Receipts from Takeovers/NNP)
(.42)

+ .03 x (Household Net Worth/NNP)
(.01)

− .22 x (Share of Population < 16)
(.06)

First-Order Autoregressive Coefficient: .39 (.18) $R^2 = .91$

The estimated coefficients on disposable income and on net worth are similar to those in earlier studies.[27] The estimates also suggest an important link between after-tax receipts from takeovers and consumer spending, with a marginal propensity to spend of .59. This coefficient is not estimated with the same precision as the coefficients on income or wealth, however. The hypothesis that this coefficient equals zero can be rejected at the 85 percent confidence level, although not the conventional 95 percent level.[28] There is also strong empirical support for the view that demographic shifts have altered the level of consumer spending. The next sub-section evaluates the substantive importance of these findings.

---

[23] Our estimates of the share of transactions involving cash payout are broadly comparable with the five-year averages, based on *value*, reported in Julian R. Franks, Robert S. Harris, and Colin Mayer, "Means of Payment in Takeovers: Results for the United Kingdom and the United States," in A. Auerbach, ed., *Corporate Takeovers: Causes and Consequences* (Chicago: University of Chicago Press, 1988). We describe alternative results using these data below.

[24] U.S. Federal Trade Commission, *Statistical Report on Mergers and Acquisitions: 1978*, Bureau of Economics, Washington, D.C., 1980. We estimated the share of merger transactions involving cash during the 1950 to 1967 period using the five-year average shares reported in Franks *et al.*

[25] The Flow of Funds includes nonprofit institutions along with individuals in the "household" sector. Although we would prefer to exclude these untaxed institutions from our definition of the household sector, that is not possible given available data. We exclude foreign equity holdings in calculating the household share because most such holdings are concentrated in subsidiaries rather than general portfolio investment. Our results are not significantly affected, and suggest a larger effect of cash payout on consumption, if we include foreign ownership in calculating the household share of equities.

[26] We do not include a constant term, but instead include the variable 1/Real Per Capita NNP, because this results when the linear specification for real per capita consumption used in most studies is deflated by net national product per capita. The numbers in parentheses are coefficient standard errors. T-ratios may be obtained by dividing the coefficient by its standard error.

[27] These results are broadly consistent with many previous empirical studies.

[28] The coefficient on cash receipts from takeovers is also somewhat sensitive to our choices regarding demographic variables.

Since our evidence that cash receipts from corporate control transactions affect consumption is the principal contribution of our econometric results, we explored the robustness of the findings in several ways. First, since our corrections for capital gains taxes are imprecise, we replaced our tax-adjusted measure of payout with the unadjusted level of cash payout. This variable has a stronger statistical effect on consumption than our corrected measure, supporting our general view of a link between cash transactions and consumption. Second, we used an alternative measure of the share of cash payout in takeovers based

**Table VII**
Household Cash Receipts from Takeover Activity

(Columns 1 and 2 are measured in billions of dollars. The data reflect the total value of mergers reported by W.T. Grimm, multiplied by the share of such mergers for cash and the share of corporate equity held by households. We also perform tax adjustments as described in the text.)

| Year | Current Dollars | Constant (1982) Dollars | Percent of NNP |
|---|---|---|---|
| 1950 | 0.0 | 0.1 | 0.0 |
| 1951 | 0.0 | 0.1 | 0.0 |
| 1952 | 0.1 | 0.2 | 0.0 |
| 1953 | 0.1 | 0.5 | 0.0 |
| 1954 | 0.3 | 0.9 | 0.1 |
| 1955 | 0.4 | 1.4 | 0.1 |
| 1956 | 0.3 | 1.1 | 0.1 |
| 1957 | 0.2 | 0.7 | 0.1 |
| 1958 | 0.2 | 0.6 | 0.0 |
| 1959 | 0.3 | 0.8 | 0.1 |
| 1960 | 0.7 | 2.0 | 0.1 |
| 1961 | 0.9 | 2.6 | 0.2 |
| 1962 | 1.0 | 2.8 | 0.2 |
| 1963 | 1.1 | 3.1 | 0.2 |
| 1964 | 1.0 | 2.8 | 0.2 |
| 1965 | 2.2 | 6.3 | 0.3 |
| 1966 | 2.3 | 6.2 | 0.3 |
| 1967 | 5.6 | 14.9 | 0.7 |
| 1968 | 10.7 | 27.3 | 1.3 |
| 1969 | 6.4 | 15.7 | 0.7 |
| 1970 | 4.3 | 9.9 | 0.5 |
| 1971 | 3.5 | 7.7 | 0.3 |
| 1972 | 4.5 | 9.6 | 0.4 |
| 1973 | 5.1 | 10.3 | 0.4 |
| 1974 | 4.4 | 7.9 | 0.3 |
| 1975 | 4.3 | 7.2 | 0.3 |
| 1976 | 7.6 | 12.1 | 0.5 |
| 1977 | 8.4 | 12.6 | 0.5 |
| 1978 | 11.7 | 16.4 | 0.6 |
| 1979 | 16.8 | 21.5 | 0.7 |
| 1980 | 16.0 | 18.5 | 0.7 |
| 1981 | 28.6 | 30.3 | 1.1 |
| 1982 | 18.7 | 18.7 | 0.7 |
| 1983 | 22.2 | 21.3 | 0.7 |
| 1984 | 44.1 | 40.8 | 1.3 |
| 1985 | 71.1 | 63.8 | 2.0 |
| 1986 | 57.5 | 50.3 | 1.5 |
| 1987 | 48.2 | 40.3 | 1.2 |

on the five-year average share rather than the annual share of cash in total payouts.[29] This increased the estimated effect to nearly the same size as the disposable income coefficient. We also recognized that not all cash payouts result from takeovers: some firms repurchase shares for reasons unrelated to corporate control. We therefore constructed a measure of gross share repurchases from the Flow of Funds and included this in our consumption models. Once again the effect was larger than the .59 effect estimated above. The other coefficients in the consumption equation were not substantially affected by these changes.

The possibility that each dollar of after-tax cash payout from corporate takeovers generates 59 cents of additional spending strikes us as implausibly large.[30] We therefore examine the robustness of our conclusions about the source of consumption changes by considering smaller spending propensities as well. Our findings clearly establish, however, that there may be important links between corporate control transactions and national saving.

### *Explaining Consumption Growth, 1970 to 1987*

To evaluate the importance of various changes in the economic environment on the share of national income devoted to consumption, we use our estimates of the aggregate consumption function to explain changes between the 1970 to 1979 and 1985 to 1987 periods. The estimated coefficients provide some guidance on the relative importance of changes in disposable income, wealth, demographic composition, and the role of corporate control transactions. The table shows our basic findings in tabular form.

Table VIII reports the mean of each of the explanatory variables from our consumption model for the 1970 to 1979 and 1985 to 1987 periods. Between these periods, the ratio of consumption to net national product increased by 4.7 percentage points. Disposable income (excluding our measure of after-tax cash from takeovers) increased by 2.1 percent of NNP. The table shows that interest receipts grew especially rapidly. Transfers net of taxes did not. While transfers rose by over 2 percent of NNP, this rise was essentially matched by growth in taxes as a share of NNP. The net effect on disposable income is therefore very small. (This stands in marked contrast to the differences between the 1960s and 1970s when transfers net of taxes increased significantly as a share of NNP.) Using our estimates of the marginal propensity to consume from disposable income of .83, the net effect of these changes has been to increase the consumption to NNP ratio by 1.8 percentage points.

**Table VIII**
Baseline Calculation of Sources of Consumption Growth

| | 1985–1987 | 1980–1987 | 1970–1979 | 1985–87 less 1970–79 | | Estimated Consumption Effect |
|---|---|---|---|---|---|---|
| Consumption/NNP | 74.0 | 73.1 | 69.3 | + 4.7 | | + 4.7 |
| Disposable Income/NNP | 79.5 | 79.7 | 77.4 | + 2.1 | x .83 = | + 1.8 |
| Labor Income/NNP | 60.6 | 61.2 | 61.5 | − 0.9 | x .83 = | − 0.7 |
| Interest Income/NNP | 13.2 | 12.8 | 8.3 | + 4.9 | x .83 = | + 4.1 |
| Other Capital Income/NNP | 10.0 | 9.7 | 12.0 | − 2.0 | x .83 = | − 1.7 |
| Transfers/NNP | 13.7 | 13.9 | 11.5 | + 2.2 | x .83 = | + 1.8 |
| Taxes/NNP | (18.0) | (17.9) | (15.9) | − 2.1 | x .83 = | − 1.7 |
| After-Tax Cash from Takeovers/NNP | 1.6 | 1.1 | 0.5 | + 1.1 | x .59 = | + 0.7 |
| Net Worth/NNP | 331.0 | 332.1 | 305.1 | +25.9 | x .03 = | + 0.8 |
| Percent of population < 16 | 24.7 | 25.2 | 29.4 | − 4.7 | x −.22 = | + 1.0 |
| Total Predicted Change in consumption/NNP | | | | | | + 4.3 |
| Unexplained Component of consumption/NNP | | | | | | 0.4 |

---

[29] The five-year averages are drawn from Franks, Harris, and Mayer, op cit.

[30] The coefficient on forced realizations may reflect more than simply the marginal propensity to spend from cash receipts. If increased takeover activity raises all share prices, for example, and this wealth effect increases consumption, our estimated coefficient could be biased upwards.

The household sector's after-tax receipts of cash income from takeovers also increased from 0.5 to 1.6 percent of NNP between 1970 to 1979 and 1985 to 1987. Given our estimate that these receipts raise consumption by 59 cents on the dollar, we attribute an increase in the consumption to NNP ratio of 0.7 percent to this shift in the economic environment. Our findings suggest similar effects from shifts in net worth. While the value of household net worth averaged 3.05 times net national product during the 1970 to 1979 period, this ratio increased to 3.31 times NNP during the more recent years. However, the small effect of net worth on consumption (.03) implies that even this large wealth change raises consumption by 0.8 percent of NNP.

Finally, our estimates imply that demographic shifts have had a significant effect on the share of national income devoted to consumption. Between 1970 and 1979, the share of the population under age 16 declined. The average share during this period was 29.4 percent. In the 1985 to 1987 period, comparison, only 24.7 percent of the population was in this age category. Given our estimate that a one percent decline in the share of the population in this age group raises the share of NNP devoted to consumption by .22 percent, we estimate that changes in the demographic mix could account for a consumption shift of 1.0 percent of NNP, or nearly one quarter of the decline between 1970 to 1979 and 1985 to 1987.

Although demographic factors can explain some of the long-run shifts in consumption patterns, they are unlikely to explain short-run variations in saving rates such as the decline between the early and mid-1980s. This is because demographic variables change very slowly, as demonstrated in Table IX. To explain significant year-to-year variation in saving rates on the basis of demographic factors, the marginal propensities to save across different groups would have to differ by far more than plausible estimates would suggest.

### *Sensitivity Analysis*

Our calculations of how changes in the U.S. economy between the 1970 to 1979 and 1985 to 1987 period, have affected consumption rely exclusively on our estimated consumption function. Since we make several important assumptions in estimation, for example by constraining all of the components of disposable income to have the same effect on consumption, some evidence on the robustness of our findings is useful.

We report one alternative calculation of consumption effects in which we assume that the marginal propensity to consume out of transfers is higher than that out of other forms of disposable income (perhaps because transfers are received by liquidity constrained households; perhaps because households assume that they are more permanent than other forms of income). We set this marginal spending propensity to unity in our alternative calculation. We also consider the possibility that the spending propensity from capital income is lower than our estimates suggest, and set both the MPC from after-tax cash income received in takeovers and the receipts from other capital income equal to .3. We do not modify our other estimated coefficients. The results of this calculation are shown in Table X on the next page.

The results are less successful than our earlier calculations in explaining the growth of consumption. The estimates still explain 60 percent of the consumption increase, however, which is substantially more than earlier studies of the saving decline have accounted for.

Our analysis has focused on comparing the experience of the 1980s with that of the previous decade. This comparison is motivated by the striking rise in U.S. consumption during the 1980s. Our estimating equation can also be used, however, to analyze changes in consumption between other time periods. One useful way of validating our model is to see if it correctly predicts the change between

**Table IX**
Share of U.S. Population
by Age Groups

| Year | <16 | 17–24 | 25–34 | 35–44 | 45-54 | 55-64 | >65 |
|---|---|---|---|---|---|---|---|
| 1950 | 0.297 | 0.119 | 0.158 | 0.142 | 0.115 | 0.088 | 0.081 |
| 1960 | 0.341 | 0.106 | 0.127 | 0.134 | 0.114 | 0.086 | 0.092 |
| 1970 | 0.321 | 0.139 | 0.123 | 0.113 | 0.114 | 0.091 | 0.098 |
| 1980 | 0.261 | 0.152 | 0.165 | 0.114 | 0.100 | 0.096 | 0.113 |
| 1985 | 0.248 | 0.135 | 0.177 | 0.133 | 0.094 | 0.093 | 0.119 |
| 1987 | 0.245 | 0.127 | 0.178 | 0.141 | 0.095 | 0.090 | 0.122 |

Table X
Alternative Calculation of Sources of Consumption Growth

| | 1985–1987 | 1970–1979 | Difference | Estimated Consumption Effect |
|---|---|---|---|---|
| Consumption/NNP | 74.0 | 69.3 | + 4.7 | + 4.7 |
| Disposable Income/NNP | 79.5 | 77.4 | + 2.1 | |
| Labor Income/NNP | 60.6 | 61.5 | − 0.9 | x .83 = − 0.7 |
| Interest Income/NNP | 13.2 | 8.3 | + 4.9 | x .30 = + 1.5 |
| Other Capital Income/NNP | 10.0 | 12.0 | − 2.0 | x .30 = − 0.6 |
| Transfers/NNP | 13.7 | 11.5 | + 2.2 | x 1.00 = + 2.2 |
| Taxes/NNP | (18.0) | (15.9) | − 2.1 | x .83 = − 1.7 |
| After-Tax Cash from Takeovers/NNP | 1.6 | 0.5 | + 1.1 | x .30 = + 0.3 |
| Net Worth/NNP | 331.0 | 305.1 | + 25.9 | x .03 = + 0.8 |
| Percent of Population < 16 | 24.7 | 29.4 | − 4.7 | x −.22 = + 1.0 |
| Total Predicted Change in Consumption/NNP | | | | + 2.8 |
| Unexplained Component of Consumption/NNP | | | | + 1.9 |

two earlier periods, say the 1960s and the 1970s. If the model significantly mispredicts in these time periods, then its reliability in accounting for the experience in the 1980s would be open to question.

Table XI reports decadal averages for the variables in our consumption function for both the 1960s and 1970s. These averages are of independent interest for their contrast with the later periods that we focused on above. Two features of the comparison between the 1960s and 1970s are striking. First, in contrast to the recent period, there was rapid growth in transfers. These payments increased from 6.9 to 11.5 percent of NNP between the 1960s and 1970s. Taxes also increased, but by only 2.6 percent of NNP. The second important pattern is the pronounced decline in

Table XI
Sources of Consumption Growth
1960–1979

| | 1970–1979 | 1960–1969 | Difference | Estimated Consumption Effect |
|---|---|---|---|---|
| Consumption/NNP | 69.3 | 68.5 | + 0.8 | + 0.8 |
| Disposable Income/NNP | 77.8 | 75.7 | + 2.1 | x .83 = + 1.7 |
| Labor Income/NNP | 61.5 | 60.0 | + 1.5 | x .83 = + 1.3 |
| Interest Income/NNP | 8.3 | 6.0 | + 2.3 | x .83 = + 1.9 |
| Other Capital Income/NNP | 12.0 | 15.7 | − 3.7 | x .83 = − 3.1 |
| Transfers/NNP | 11.5 | 6.9 | + 4.6 | x .83 = + 3.8 |
| Taxes/NNP | (15.9) | (13.3) | − 2.6 | x .83 = − 2.2 |
| After-Tax Cash from Takeovers/NNP | 0.5 | 0.4 | + 0.1 | x .59 = + 0.1 |
| Net Worth/NNP | 305.1 | 341.1 | − 36.0 | x .03 = − 1.1 |
| Percent of Population < 16 | 29.4 | 33.9 | − 4.5 | x −.22 = + 0.9 |
| Total Predicted Change in Consumption/NNP | | | | + 1.6 |
| Unexplained Component of Consumption/NNP | | | | + 0.9 |

household net worth as a share of NNP. While net worth averaged 3.41 times national income during the 1960s, the decline in the national debt as percent of NNP combined with the decline in stock market values during the 1970s reduced this average to only 3.05. The 1980s have witnessed a rebound in the ratio of net worth to NNP, but not to the level of the 1960s.

The last column of Table XI shows the predicted change in consumption as a share of NNP from each of the components of our consumption equation. The results provide encouraging evidence on the predictive power of this model. Between the 1960s and the 1970s, the consumption share of national income increased by 0.8 percent. Our equation predicts a 1.6 percentage point increase which consists of a 2.7 percentage point increase due to changes in disposable income, demography, and cash receipts from takeovers, which is partly offset by a 1.1 percent decline attributed to changing wealth. Although the equation does not predict the actual change exactly, it yields a reasonable estimate (and correctly predicts the direction) of the consumption change. ■

# Appendix II:

## Why Has Leverage Increased?

Growth in corporate leverage during the 1980s is the result of many different factors. First, the tax incentives for corporate borrowing have increased during the last decade. The relative tax burden on debt vs. equity depends on both corporate and investor taxes. The general trend toward reductions in individual tax rates (from a maximum rate of 70 percent in 1980 to 28 percent today) has reduced the net tax burden on interest payments and made corporate borrowing more attractive relative to equity.

A simple example, presented in detail in Table XII, illustrates the changing tax posture toward debt. In 1980, a firm earning one dollar in pretax profits and using equity finance would have 54 cents available after-tax for equityholders (the marginal corporate tax rate was 46 percent). If all of this after-tax profit was reinvested, then a shareholder in the top tax bracket would eventually pay a capital gains tax of 28 percent and would receive 39 cents after all taxes. This makes the conservative (high-tax) assumption that capital gains are taxed at their statutory rate of 28 percent and neglects the benefit resulting from deferral of tax liability until gains are realized. For a bond-financed project, the firm would pay no tax, the interest recipient would pay personal income tax of 70 cents per dollar of interest income and would receive 30 cents after all taxes. Thus, from the perspective of the top-bracket investor, the tax burden on equity and debt gave a preference to equity.

The lower panel of Table XII examines the company's tax burden in 1987. The same investor providing funds to the same firm would earn an after-tax return of 72 cents on a debt-financed project, compared with 48 cents for an equity-financed project. The after-tax return from a debt-financed project is now significantly larger than that from an equity-financed project, just the opposite of the situation before the 1981 tax reform. Thus, for high-bracket individual investors, the incentive for holding corporate debt has grown significantly during the 1980s.[31]

A second consideration encouraging higher borrowing is the development of financial institutions that reduce the costs of bankruptcy and near-bankruptcy. An obvious example of this is "strip-financing," a technique whereby investors who purchase low-grade corporate debt also re-

---

[31] The 1981 tax reform clearly encouraged leverage. The net effect of the 1986 tax reform is less clear. For tax exempt investors, for example, corporate tax rate reductions have made equity more attractive relative to debt. On balance, however, there is little question that during the mid-1980s leverage has been more attractive than in previous decades.

**Table XII**
Tax Burdens on Debt—and Equity—Financed Projects 1980 and 1987

(All calculations pertain to the marginal tax burdens facing an individual investor in the top marginal tax bracket for interest income, dividends, and capital gains.)

| 1980 Tax Rules | All Debt Project | All Equity Project<br>Payout Rate = 0 | Payout Rate = .5 |
|---|---|---|---|
| Pretax Corporate Earnings | 100 | 100 | 100 |
| Corporate Taxes | 0 | (46) | (46) |
| Investor Taxes |  |  |  |
| Interest and Dividends | (70) | 0 | (18) |
| Capital Gains | 0 | (15) | ( 8) |
| After-Tax Income to Investor | 30 | 39 | 28 |

| 1987 Tax Rules | All Debt Project | All Equity Project<br>Payout Rate = 0 | Payout Rate = .5 |
|---|---|---|---|
| Pretax Corporate Earnings | 100 | 100 | 100 |
| Corporate Taxes | 0 | (34) | (34) |
| Investor Taxes |  |  |  |
| Interest and Dividends | (28) | 0 | ( 9) |
| Capital Gains | 0 | (18) | ( 9) |
| After-Tax Income to Investor | 72 | 48 | 48 |

ceive part of the firm's equity and possibly other debt instruments as well. This technique aligns the interests of corporate debt and equity claimants, thereby avoiding some of the traditional costs of inter-claimant bargaining that affected debt- ridden firms on the edge of bankruptcy in past decades. Strip-financing violates the separation of debtors from equity holders that was traditionally enforced by the Internal Revenue Service in the past.

The net effect of these incentives has been a significant increase in corporate leverage during the 1980s. In every year since 1983 equity retirements exceeded new equity issues by large amounts. In 1987, net equity retirements were $77 billion while debt grew by $154 billion. Projections for 1988 suggest even more rapid growth in leverage. In the second quarter of 1988 net equity retirements rose to an annual rate of $140 billion while debt increased at an annual rate of $214 billion. The results of growing leverage are shown in Table XIII, which describes the decline in both gross and net interest coverage. Gross interest coverage, which rarely was less than 3 prior to 1980, has been less than 2 in each of the last five years. Net interest coverage, which subtracts interest received by business from gross interest payments, has also declined.

The table also presents another measure of corporate leverage, the debt-equity ratio. This ratio has not increased much. The increase in stock market values over the last decade has kept the debt-equity ratio computed at market value from rising. It must be pointed out, however, that neither corporate managers, nor banks, nor credit rating agencies consider debt as a percent of market value of

**Table XIII**
Interest Share Ratios & Debt-Equity Ratio Nonfinancial Corporations 1960–1987

Source. National Income and Product Accounts and Flow of Funds. Debt-equity ratio is calculated using market value of equity. Interest coverage is pretax income plus interest divided by interest.

| | Net Interest Coverage | Gross Interest Coverage | Debt-Equity Ratio |
|---|---|---|---|
| 1960 | 12.3 | 6.2 | 43.4 |
| 1961 | 10.9 | 5.9 | 38.2 |
| 1962 | 10.8 | 5.9 | 45.2 |
| 1963 | 11.2 | 5.8 | 41.3 |
| 1964 | 11.5 | 6.0 | 39.4 |
| 1965 | 11.7 | 6.4 | 39.7 |
| 1966 | 10.5 | 5.9 | 48.2 |
| 1967 | 8.6 | 5.0 | 41.1 |
| 1968 | 8.2 | 4.7 | 40.1 |
| 1969 | 6.3 | 3.7 | 50.1 |
| 1970 | 4.3 | 2.8 | 54.3 |
| 1971 | 4.6 | 3.0 | 49.8 |
| 1972 | 5.0 | 3.2 | 47.8 |
| 1973 | 5.3 | 3.2 | 68.9 |
| 1974 | 4.8 | 2.9 | 103.9 |
| 1975 | 4.8 | 2.9 | 77.9 |
| 1976 | 6.0 | 3.4 | 72.4 |
| 1977 | 6.2 | 3.5 | 85.4 |
| 1978 | 6.1 | 3.3 | 91.4 |
| 1979 | 5.5 | 2.9 | 82.9 |
| 1980 | 4.3 | 2.4 | 64.1 |
| 1981 | 3.7 | 2.0 | 76.2 |
| 1982 | 2.7 | 1.7 | 69.8 |
| 1983 | 3.3 | 1.9 | 62.4 |
| 1984 | 3.4 | 1.9 | 74.0 |
| 1985 | 3.1 | 1.7 | 65.8 |
| 1986 | 3.0 | 1.7 | 64.5 |
| 1987 | 3.1 | 1.8 | 73.5 |

equity as a meaningful indicator of the financial soundness of a corporate balance sheet. Interest coverage and other factors are much more relevant.

The aggregate statistics on both interest coverage and the debt-equity ratio mask important variations across firms. For some firms that have been recently involved in leveraged buy outs, for example, debt burdens are much higher than on average. These are the firms that would be at risk if interest rates rose or the economy entered a recession. ■

# Appendix III:

## Potential Effects of Saving Incentives

Although empirical studies of how rates of return affect private saving are inconclusive, there are two recent sources of evidence suggesting that raising the after-tax return to saving might draw forth a private saving response.

First, evidence on the IRA experiment of the early 1980s compiled by Venti and Wise suggests that only about thirty cents of each dollar contributed to IRAs was drawn from other saving instruments. As much as seventy cents per dollar was "new saving," money that would have been spent or paid in taxes were it not for IRAs. The sharp decline (more than fifty percent) in IRA participation in 1987, when contributions were no longer deductible for many households, further supports the view that interest incentives can affect saving.

Second, comparisons of saving behavior in the United States and Canada reveal an interesting pattern: the saving rate in Canada has diverged from that in the United States for the last decade, coincident with the introduction and widespread use of tax-sheltered saving plans for home purchase and retirement. Estimates by Carroll and Summers suggest that each dollar of sheltered saving raises the Canadian saving rate by at least one dollar relative to its U.S. counterpart. This may even suggest that widespread availability of such sheltered accounts promotes a culture of saving in which households devote more attention to future plans and the need for deferring consumption. ■

# Appendix IV:

## Effect of Revenue-Neutral Changes in Corporate Taxation on the Cost of Capital

We shall examine the effect on the cost of capital of two revenue-neutral alternatives to the present structure of corporate taxation. Under alternative 1 the deductibility of interest payments is eliminated and the resulting increase in corporate taxation is offset by a lowering of the corporate tax rate. Under alternative 2 the deductibility of interest payments is replaced by a general deduction for both equity and debt at a fixed percentage of total corporate capitalization such that the government revenue is not altered.

The real cost of capital c for corporate investments net of depreciation is given by the general expression

$$c = \frac{1 - \tau Z}{1 - \tau}(\rho^* + \delta) - \delta$$

where $\tau$ is the corporate tax rate at the margin
$\rho^*$ is the real after-tax cost of funds
$\pi$ is the inflation rate
$\delta$ is the depreciation rate of the asset
$\delta_a$ is the depreciation rate allowed for the asset by the tax code and $Z$ is the present value of depreciation allowance.

The present value of depreciation allowances $Z$ equals $\delta_a/(\rho^* + \pi + \delta_a)$. This present value approaches zero with increased inflation and approaches unity with accelerated depreciation allowances.

The real after-tax cost of funds for a firm is the average of its real cost of equity and its real cost of debt, weighted by the relative amounts of equity and debt used to finance a new project. The costs of equity and debt are determined by the requirements of stockholders and creditors, respectively. For example, assume that stockholders demand, on average, a return of 12 percent on equity investments and creditors an interest rate of 10 percent on corporate bonds. Moreover, let the inflation rate be 4 percent. The real after-tax cost of equity for the average corporation would be 8 percent (12 percent less 4 percent). The real after-tax cost of debt, however, is not 10 percent less 4 percent, because interest payments are deductible. If the corporate tax rate is 40 percent (say 34 percent federal and 9 percent state) then the real after tax cost of debt would be 10 x (1-0.4) - 4 = 2 percent. For a firm that uses 50 percent equity funds and 50 percent borrowed funds to make investments, the real cost of funds is 0.5 x 8 + 0.5 x 2 = 5 percent. For this cost of funds, the cost of capital c for an investment whose economic depreciation rate is 10 percent per year is 9.7 percent if the tax code allows economic depreciation, 8.1 percent if it allows double-declining-balance depreciation, and 5 percent if it allows expensing.

---

[illegible]

This expression is based on the approach first proposed by R.E. Hall and D.W. Jorgenson, "Tax Policy and Investment Behavior," American Economic Review 57, June 1967, 391-414.

**Table XIV**
Cost of Capital Under Various Taxation Alternatives

| Depreciation Allowances: | Current Law | Alternative 1 | Alternative 2 |
|---|---|---|---|
| Economic<br>equal 10 percent | 9.7 | 10.6 | 9.7 |
| Double Declining<br>equal 20 percent | 8.1 | 9.2 | 8.1 |
| Expensing | 5.0 | 7.0 | 5.0 |

Consider now the two modifications of the tax law. Under the first alternative, corporations lose the tax deduction on interest payments but pay the same taxes because the corporate tax rate is lowered. To calculate what the new corporate tax rate would have to be, we assume a pretax corporate return of 20 percent (this would produce an after-tax return equal to the cost of equity, i.e. 12 percent). It is further assumed that this pretax return on equity would not be altered as a result of the enactment of the tax change.[36] Accordingly, the new tax rate is calculated to be 29 percent (22 percent federal and 9 percent state). The marginal real cost of funds for the firm under this alternative will be

$$0.5x(12-4) + 0.5(10-4) = 7 \text{ percent}$$

The resulting cost of capital for an asset having a depreciation rate of 10 percent per year rises from 9.7 to 10.6 percent if the tax code provides for economic depreciation, 8.1 to 9.5 percent if it provides for double-declining-depreciation, and 5.0 to 7.0 percent if it provides for expensing as it does for investments in research and development.

Under the second alternative, the deduction on debt is lowered from 10 percent, which is the assumed average interest rate, to a standard 5 percent. This deduction is also extended to equity capital at a fixed 5 percent rate. Thus, although the real cost of debt to corporations increases the real cost of equity will decline, resulting in no change in the cost of funds and, therefore, no change in the cost of capital.[37]

The results are summarized in Table XIV. Alternative 2 is more attractive than alternative 1 because it does not raise the cost of capital and discourage new investment.

The disadvantage of alternative 1 versus either current law or alternative 2 is more pronounced for investments in research and development that can be fully expensed. In fact, since such investments can be financed in practice only with equity, alternative 2 provides stronger investment incentives than current law. ■

---

[36] In the long run, reductions in the corporate tax rate are likely to lead to lower pre-tax returns.

[37] For firms using more debt than equity in their capital structure, this change would raise the cost of capital. It would have an opposite effect on firms using mostly equity finance.

Chairman Rostenkowski. Mr. Roberts.

## STATEMENT OF PETER A. ROBERTS, CHAIRMAN AND CHIEF EXECUTIVE OFFICER, COLLEGE SAVINGS BANK, PRINCETON, NJ

Mr. Roberts. Thank you, Chairman Rostenkowski, and other members of the committee for inviting me to speak today.

Briefly, I am Peter Roberts. I am chairman and chief executive officer of the College Savings Bank, Princeton, N.J.

Several years ago, I was sitting around the Thanksgiving dinner table with my brother and sister-in-law, who have three young children, and they asked me, Peter, how shall we save for our children's college education?

My first reaction was why don't you buy some zero-coupon bonds. But then my brother said to me, well, what if inflation and interest rates go up? And I had to admit that his kid's college education would end up being underfunded. We went through a whole litany of investment alternatives, stocks, bonds, mutual funds, et cetera, but none of them could guarantee the cost of college when his kids were ready to go to college.

In frustration my brother said to me, Peter, all I really want to do is prepay my kids' college education. That was the genesis of the College Savings Bank and the CollegeSure CD. The CollegeSure CD. is a college cost prepayment product. It is a variable rate certificate of deposit guaranteed to pay at maturity the future cost of college. It is indexed to the college inflation rate. We thought this was an important innovation and would increase savings at the margin to help families reach their college goals.

Within the past decade, alone, college costs have more than doubled. They have outpaced disposable income per capita while the personal savings rate per capita has only increased by 16 percent. The average cost of 1 year's undergraduate college education at a typical private college is in excess of $12,000 per year. And if college inflation goes on as it has in this decade, at a 10 percent rate, that cost of college will be $61,000 per year in 16 years, or 4 years of college will cost a quarter of a million dollars.

One solution to helping families save for college is to provide tax incentives. However, the tax incentives have to be carefully designed so as to permit college savers sufficient investment flexibility and encourage the participation of the private sector.

Congress recently took an important first step by enacting legislation to provide incentives for college savings. The Technical and Miscellaneous Revenue Act of 1988 had a provision that accords tax-exempt status to the interest earned on the series EE bond if at redemption the proceeds are used to pay for college education costs. The provision applies to bonds purchased after January 1, 1990, and it is for parents with income below specified levels.

In the short run, this might increase college-targeted savings and we all hope overall savings. However, the provision which was added on the Senate floor and which was never considered either in hearings or markup by this full committee, has several significant flaws with long term consequences.

The new saving for college tax incentive converts the series EE bond into a tax-exempt bond at a taxable yield. This form of tax incentive will divert the portion of a family's total savings earmarked for college away from other forms of investment and into the series EE bond. The disintermediation and market-damaging effects caused by a preemptive Federal savings product will have a decidedly negative impact on competition and innovation, not to mention the adverse marginal impact on the savings and loan crisis. It will discourage those institutions that now seek to help college savers and reduce the range and variety of targeted college savings vehicles.

Let me give you a personal example. In 1987 the College Savings Bank introduced the innovative CollegeSure CD. It allows parents to invest in their child's college education today for just a fraction of tomorrow's cost.

In addition, the bank developed, with the approval of the FDIC, safe and sound banking practices which insured against this future liability. We thought these developments were major steps forward in encouraging savings for education. Apparently so do the many States the bank has advised and the growing number of colleges and universities that participate in our program. Michigan, Florida, and Wyoming have enacted these programs. I wonder if these innovative and important saving programs would have been developed if a preemptive Government college savings instrument had been available 3 years ago? In fact, the State of Minnesota, citing the new series EE bond, aborted its recent college savings initiative.

In addition, the series EE bond will distort investor choices. Given that the tax incentive is restricted to one savings product it will alter a family's choice of investments, but will not necessarily increase the family's total volume of savings.

One test of every initiative offered in the name of progress is whether it is in harmony with sound economic principles. While the goals of the series EE savings bond legislation are admirable, and its author should be given credit for developing a low cost incentive, it fails this important test.

The best way to maximize the effectiveness of the tax benefit offered to college savers would be to extend the tax incentives granted series EE bonds to all financial instruments placed in a qualified college savings account. Contributions to a college savings account would not be currently deductible but earnings in the account would be tax exempt if used for qualified college education expenses.

The expanded program could be structured in such a way as to make sure it does not cost any more than the Treasury estimated that the series EE bond college savings incentive would cost. Notwithstanding, revenue neutrality should not constrain the development of an economically efficient college savings incentive for the middle class.

The college savings account would help level the playing field for all market participants and avoid the market-damaging effects caused by a preemptive Federal savings product. The private sector has a comparative ability to cultivate thrift among this Nation's families. It can provide college savers with a wide range of investment services, reach a broader spectrum of eligible families, and create a competitive and innovative marketplace that is necessary to maximize the savings rate in this great country.

I urge this committee to act quickly to effectuate legislation to expand the college savings incentive to the private sector by January 1, 1990, the effective date of the series EE savings bond legislation. Delay will not only be disruptive to the saving-for-college marketplace, but could also have serious and adverse long-term effects. Let's not crowd out the private sector.

I thank the Chairman and the committee for this opportunity to express my views today.

Chairman ROSTENKOWSKI. Thank you, Mr. Roberts.

[The statement of Mr. Roberts follows:]

## STATEMENT OF PETER A. ROBERTS
## CHAIRMAN AND CHIEF EXECUTIVE OFFICER, COLLEGE SAVINGS BANK

## THE COLLEGE SAVINGS CRISIS:
## PREEMPTIVE FEDERAL SAVINGS PRODUCTS ARE NOT THE RIGHT SOLUTION

I would like to thank Chairman Rostenkowski and other members of the Ways and Means Committee for giving me this opportunity to discuss the role that the private sector can play in helping to increase the rate of saving in the United States and, in particular, the rate of saving for a college education.

Briefly, I am the Chairman and Chief Executive Officer of the College Savings Bank, a New Jersey-chartered, FDIC-insured savings bank located in Princeton.

The College Savings Bank was formed for the primary purpose of originating and marketing the CollegeSure CD, America's premier college cost prepayment product.

I am also the inventor of the CollegeSure CD.

### The College Savings Crisis

Most parents feel obligated to contribute toward the cost of their children's college education.[1] But only about half the families who plan to have one of their children attend college are currently saving for college, and the median savings level is under $600 per year. Even among families earning $30,000 or more per year, only 70% are saving for their children's college education, and the median total savings level (e.g. for college, retirement, home, etc.) is roughly $1,000 per year. Those who are not currently saving for their children's college education but plan to do so later expect to start saving when their child is 12 years old, which only leaves six years to save before the child matriculates.[2] Such savings programs are likely to leave families financially unprepared to pay for their children's college education.

### Dimensions of the College Savings Crisis

As college costs soar, more and more families are struggling with the task of planning how to finance the cost of their children's college education -- a cost that threatens to escalate beyond their reach. The persistently high rates of college inflation present an imposing challenge. Based on data compiled by the College Board, college costs at private institutions have increased since 1981 at an average rate of 10% per annum, more than double the rate of inflation in consumer prices.[3] Even at the 7.89% rate of college cost inflation for 1988, direct charges (tuition, mandatory fees, room and board) for four years at the average private institution, currently $12,205 per year, would cost a member of the class of 2004 more than $136,000.[4]

---

[1] A recent survey found that 66% of the parents interviewed felt they had the primary responsibility for financing their children's college education. Roper Organization, "A National Study on Parental Savings for Children's Higher Education Expenses," National Institute of Independent Colleges and Universities, Washington, DC, August 1984, p. 5.

[2] Ibid., pp. 4, 11. The study found an overall median saving level of $517 per annum and a median saving level of $904 per annum for families with incomes of $30,000 or more. Adjusting these figures based on the change in the consumer price index since 1984 indicates median saving levels of $594 and $1,039 per annum, respectively. Not surprisingly, the study also found that 74% of the individuals surveyed favored some form of federal tax incentive to promote saving for college.

Table 1 compares the rates of increase in direct charges at public and private universities to increases in the cost of various consumer goods and services and to changes in the average family's ability to pay for college, as measured by disposable personal income per capita and also by personal saving per capita. During each period, both private university and public university direct charges increased substantially faster than personal saving per capita. Table 1 indicates that the gap between college costs and family savings is widening at an alarming rate. Within the past decade, public university and private university direct charges more than doubled, but personal saving per capita increased only 16%.

## Table 1

Percentage Changes in Undergraduate Direct Charges, Personal Income and Saving Per Capita, and Consumer Prices, 1957-1986

| | Percentage Change | | |
|---|---|---|---|
| | 1957to1986 | 1967to1986 | 1977to1986 |
| Tuition, Fees, Room and Board: | | | |
| Private Universities | 691.3% | 366.4% | 135.8% |
| Public Universities | 431.0 | 264.5 | 101.4 |
| Income and Saving Per Capita: | | | |
| Disposable Personal Income Per Capita | 571.7 | 335.3 | 96.5 |
| Personal Saving Per Capita | 263.6 | 112.4 | 16.2 |
| Consumer Prices: (a) | | | |
| All Items | 289.6 | 228.4 | 80.9 |
| Food | 276.6 | 219.7 | 66.3 |
| Rent (Residential) | 220.0 | 180.0 | 82.4 |
| Energy | 311.0 | 270.3 | 78.6 |
| Medical Care Services | 615.4 | 368.6 | 116.2 |
| All Services | 429.8 | 300.5 | 106.1 |

(a) Based on year-to-year changes.

Sources: Digest of Education Statistics, Center for Education Statistics, U.S. Department of Education, Washington, DC, various issues, and Economic Report of the President, U.S. Government Printing Office, Washington, DC, January 1987, pp. 274-275, 307-310.

---

[3] The college cost inflation figure is based on the annual rate of change in direct charges at private colleges as measured by the Independent College 500™ Index (the IC 500™), which is prepared annually by the College Board. The index is described in "Independent College 500™ Index", College Scholarship Service, New York, July 31, 1988. During the period 1981 - 1988, the average annual rate of change in the CPI was 4.6% per annum.

[4] The enrollment-weighted average direct charges for 1988-89 at the 500 private colleges that comprise the IC 500 are $12,205.

The widening gulf between college costs and college savings is the result of two factors: the very high rate of college inflation relative to price inflation generally and the declining personal saving rate. Table 1 reports that university direct charges have increased substantially faster than consumer prices generally but more or less in line with the rising cost of medical care services, whose sharp rates of increase have attracted considerable public attention in recent years. This reflects many parents' worst fears: having one child in college -- and a second one in the hospital.

The pattern of college costs relative to consumer price inflation depicted in Table 1 reflects the longer term historical trend in college inflation. A landmark study authored by William G. Bowen and presented to the Joint Economic Committee of Congress in 1969 reported that during the three "normal" peacetime periods between 1905 and 1966, direct costs per student increased at an average annual rate of 7.7% per annum, whereas an economy-wide cost index increased at an average annual rate of 1.9% per annum.[5] College educational costs rose more than four times as fast as costs did economy-wide.

Table 2 indicates the deterioration in the personal saving rate that has taken place since the early 1970s. The annual personal saving rate peaked at 9.4% in 1973 and has decreased more or less steadily since then to 3.9% in 1986 and a five-year average of only 5.5% for the period 1982 - 1986. Reliable direct data concerning saving rates for college are not available. However, because saving for a child's college education ranks first or second for most families who expect to send a child to college, the personal saving trend illustrated in Table 2 is probably indicative also of the trend in saving for college.[6]

A perspective on the seriousness of the deterioration in the college saving rate is provided in Table 2. If the average level of personal saving for a typical family of four were dedicated entirely to paying college costs for the two children, it would take 8.3 years' savings, based on the five-year annual average for 1982 - 1986, to fund direct charges at the average private university -- up by two-thirds from the comparable period a decade ago -- and 3.2 years' savings to fund direct charges at the average public university -- up by half from the comparable period a decade ago. But savings are also required for other purposes and college costs include costs in addition to direct charges, so the situation is more serious than the one depicted in Table 2.

College costs are likely to continue outpacing consumer prices by a wide margin in the future and college savings, if present trends continue, will prove inadequate. Middle income families, who are to an increasing extent finding themselves with insufficient resources to pay the ever-increasing cost of college by themselves but with an overabundance of resources to qualify for financial aid, are likely to be most seriously affected. These families need effective college saving vehicles and appropriate saving incentives to help them reach their college goals.

---

[5] William G. Bowen, "Economic Pressures on the Major Private Universities," in The Economics and Financing of Higher Education in the United States, submitted to the Joint Economic Committee, 91st Congress, Washington, DC, 1969, pp. 399-439. Bowen's study goes on to explain why college cost inflation should persistently outpace consumer price inflation.

[6] The Roper study cited in footnote 1 found that saving for a child's college education ranked as the second most important reason for saving, behind emergencies, but ahead of retirement and other purposes. Op.cit., p. 4.

### Table 2

### Number of Years' Saving to Fund One Year's Direct Charges

|  |  | Direct Charges as % of Disposable Income Per Capita(b) |  | Number of Years' Saving to Fund One Year's Direct Charges(c) |  |
|---|---|---|---|---|---|
| Period | Personal Saving Rate(a) | Private Universities | Public Universities | Private Universities | Public Universities |
| 1957-1961 | 6.7% | 87.7% | 45.7% | 6.5 yrs | 3.4 yrs |
| 1962-1966 | 6.6 | 93.3 | 45.2 | 7.1 | 3.4 |
| 1967-1971 | 7.6 | 89.8 | 42.0 | 5.9 | 2.8 |
| 1972-1976 | 8.6 | 84.3 | 37.7 | 4.9 | 2.2 |
| 1977-1981 | 7.0 | 78.6 | 33.1 | 5.6 | 2.4 |
| 1982-1986 | 5.5 | 91.8 | 35.1 | 8.3 | 3.2 |

---

(a) Average annual value of personal saving as a percentage of disposable personal income.

(b) Average annual undergraduate tuition, fees, room, and board as a percentage of disposable personal income per capita.

(c) Average annual direct charges as a percentage of disposable personal income per capita divided by twice the average annual personal saving rate. Calculation assumes a family of four with two children both of whom will attend college.

Sources: *Digest of Education Statistics*, Center for Education Statistics, U.S. Department of Education, Washington, DC, various issues, and *Economic Report of the President*, U.S. Government Printing Office, Washington, DC, January 1987, pp. 274-275.

## The Wrong Solution: A Preemptive Federal Savings Product

One solution to increasing the rate at which families save for college is to provide tax incentives. However, the tax incentives have to be carefully designed so as to permit college savers sufficient investment flexibility and encourage the participation of the private sector.

Congress recently took an important first step by enacting legislation that provides an incentive for college savings. The Technical and Miscellaneous Revenue Act of 1988 includes a provision that accords tax-exempt status to the interest earned on Series EE bonds if, at redemption, the proceeds are used to pay for college education costs. The provision applies to bonds purchased after January 1, 1990, if the parents' income is below specified levels at the time of redemption.

In the short-run, this might increase college-targeted savings and, we all hope, overall savings. However, the provision, which was added on the Senate floor and which was never considered either in hearings or mark-up by this full Committee, has several significant flaws with long-term consequences.

The new saving-for-college tax incentive converts the Series EE Savings Bond into a tax-exempt bond with a yield matching the taxable yields on other U.S. Treasury obligations (see Figure 1).

The effect of tax exemption on the new Series EE Bond is very different than the effect of tax exemption on a municipal bond. Whereas the market adjusts the yield on municipal bonds to be lower than the yield on taxable bonds, the yield on the non-negotiable Series EE Bond is pegged to the yield on taxable Treasury bonds and therefore cannot seek equilibrium to the yields on other tax-exempt instruments. On a risk-adjusted basis, the after-tax rate of return on the Series EE Savings Bond preempts all other investments in the marketplace (see Figure 2).

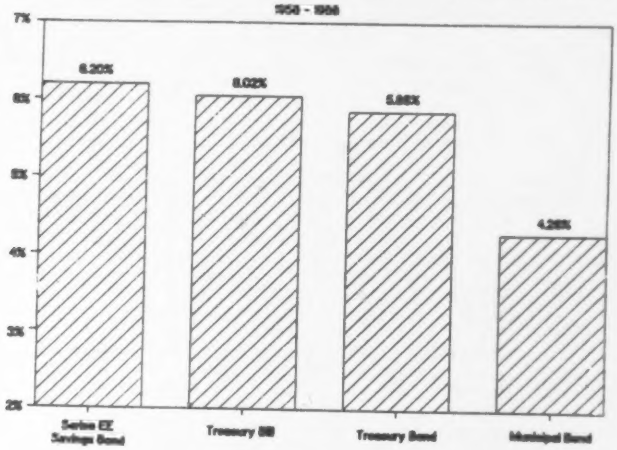
This form of tax incentive will divert the portion of a family's total savings earmarked for college away from other forms of saving and into the Series EE Bonds. The disintermediation and market-damaging effects caused by a preemptive federal savings product will have a decidedly negative impact on competition and innovation (not to mention the adverse marginal impact on the savings and loan crisis). It will discourage the institutions that now seek to help college savers and reduce the range and variety of targeted college saving vehicles.

Let me give you a personal example. In 1987, the College Savings Bank introduced an innovative certificate of deposit that bears interest tied to the rate of college inflation and guarantees the future cost of college. It allows parents to invest in their child's college education today for just a fraction of tomorrow's cost. In addition the Bank developed, with the approval of the FDIC, safe and sound banking practices which insure against this future liability. We thought these developments were major steps forward in encouraging savings for education.

Apparently so do the states that the Bank has advised and the growing number of colleges and universities that participate in our program. Michigan, Florida, Wyoming, and Indiana have enacted college cost prepayment programs. I wonder whether any of these innovative and important savings programs would have been developed if a preemptive government college savings instrument had been available three years ago.

Figure 1

## Average Annual Pre-Tax Rates of Return on Selected U.S. Treasury and Municipal Securities



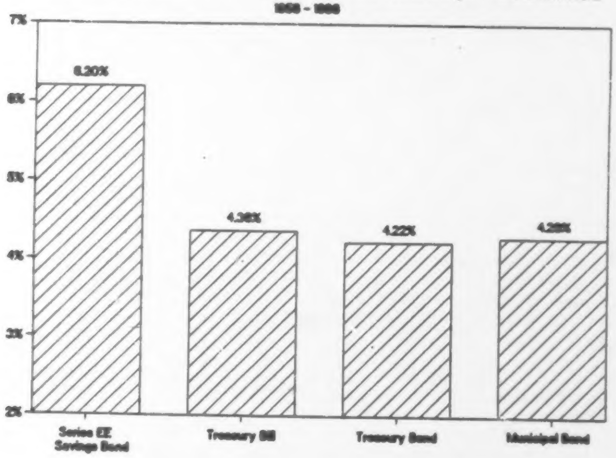
(a) Average annual rate of return on the U.S. Series EE Savings Bond was calculated retrospectively, as though the Series EE Bond had been in existence since 1958, based on 85% of the average annual yield of the 5-year constant maturity U.S. Treasury note, for the period since 1974, and 85% of the average annual yield of 3- to 5-year issues, for the period prior to 1974, in both cases as reported in various issues of the "Federal Reserve Bulletin". The floor rate and the early redemption penalties were not included in the calculation of the average annual rate of return.

(b) Average annual rates of return on U.S. Treasury bonds and U.S. Treasury bills were calculated from total annual returns for the period 1958-1988 reported in "Stocks, Bonds, Bills and Inflation, 1989 Yearbook", Ibbotson Associates, Inc., Chicago, 1989.

(c) Average annual rate of return on municipal bonds was calculated in the same manner as Ibbotson Associates computed annual Treasury returns based on monthly yield data for 10-year municipal bonds reported in "Analytical Record of Yields and Yield Spreads", Salomon Brothers Inc., New York, June 1986 and monthly updates through January 1989.

Figure 2

## Average Annual After-Tax Rates of Return on Selected U.S. Treasury and Municipal Securities



(a) Assumes a 28% marginal income tax rate

(b) The Series EE Savings Bond also provides a tax-deferred rate of return if the proceeds are applied to uses other than college savings. A 6.20% pre-tax rate yields a 4.77% tax-deferred rate if the bonds are held for 10 years.

© Copyright College Savings Bank 1989 All Rights Reserved

Furthermore, the Series EE Bond will distort investor choices. Given that the tax incentive is restricted to just one savings product, it will alter a family's choice of investments but will not necessarily increase the family's total volume of savings.

One test of every initiative offered in the name of progress is whether it is in harmony with sound economic principles. While the goals of the Series EE Savings Bond legislation are admirable -- and its authors should be given credit for developing a low-cost incentive -- it fails this important test.

## The Right Solution: A Level Playing Field

The best way to maximize the effectiveness of the tax benefits offered to college savers would be to extend the tax incentives granted to the Series EE Savings Bond to all financial instruments placed in a qualified College Savings Account. Contributions to a CSA would not be currently deductible but earnings in a CSA would be tax exempt if the CSA were used for qualified college educational expenses. The expanded program could be structured in such a way as to make sure that it does not cost any more than the Treasury estimated that the Series EE Bond college savings incentive would cost. Notwithstanding, revenue neutrality should not constrain the development of an economically efficient college savings incentive for the middle class.

The CSA would help level the playing field for all market participants and avoid the market-damaging effects caused by a preemptive federal savings product. The private sector has a comparative ability to cultivate thrift among this nation's families. It can provide college savers with a wide range of investment choices, reach a broader spectrum of eligible families, and create a competitive and innovative marketplace that is necessary to maximize the savings rate in this great country.

I urge this Committee to act quickly to effectuate legislation to expand the college savings incentive to the private sector by January 1, 1990 (Series EE Bond effective date). Delay will not only be disruptive to the saving-for-college marketplace but could also have serious and adverse long-term effects.

## Conclusion

Like others who will testify today and tomorrow, I strongly believe that there is a need to increase savings in this country. As a general rule, however, individuals have difficulty seeing the benefits -- particularly the long-term benefits to the economy -- of increased savings. College savings is one area where individuals can see the benefits of saving and an area where there is a shortage of savings. Therefore, it is an area where saving incentives are most needed and can be most effective. To be truly effective, however, incentives must not crowd out the private sector.

I thank the Chairman and the Committee for the opportunity to express my views today.

Appendix I

## COLLEGE SAVINGS ACCOUNTS

### Partial Summary of Terms

**Eligible Investments**

Investments generally eligible for IRAs, Series EE Savings Bonds, college savings programs sponsored by states, etc.

**Deductibility of Contributions**

Contributions to CSAs will not be tax deductible.

**Taxation of Earnings of CSAs**

Earnings (interest and dividends) will not be taxed currently.

**Exclusion from Income**

Earnings that are part of qualified withdrawals will be excluded from income to the extent of qualified higher education expenses paid by the taxpayer.

**General Limit on Annual Contributions**

$10,000 per taxable year by parents. Income test similar to Series EE Bond legislation except applied at time of contribution instead of time of withdrawal. Contribution limit would be phased down for higher income families (possibly using the same phasedown ranges as the Series EE bond college savings program). The contribution limit and phasedown range would be indexed for inflation.

**Holding Periods**

Amounts held in CSAs (other than Series EE bonds) would have to be held five years to be eligible for favorable tax treatment.

**Penalties; Nonqualified Withdrawals**

In the case of a nonqualified withdrawal, e.g., a withdrawal that is not used to pay "qualified higher education expenses," or a disqualification of a CSA because the taxpayer ceased to have any children below college graduation age, the taxpayer generally would be required to include in income for the year of withdrawal the earnings that are part of the nonqualified withdrawal (and which would have been included in income in a prior year but for the CSA) and pay a penalty.

**Effective Date**

January 1, 1990. This would expand the Series EE Bond college savings program scheduled to become effective on that date.

Chairman ROSTENKOWSKI. Mr. Pozen.

## STATEMENT OF ROBERT C. POZEN, GENERAL COUNSEL AND MANAGING DIRECTOR, FIDELITY INVESTMENTS, BOSTON, MA

Mr. POZEN. Thank you, Mr. Chairman.

I am from Fidelity Investments in Boston, which manages over $90 billion in assets, including about $30 billion in retirement assets. In the first part of my testimony, I would like to follow up on Peter Roberts' remarks and try to make them a little more specific about college savings.

In the second part, I would like to talk about a proposal that we have developed to broaden the current IRA program.

On the first proposal, as the committee knows, the EE savings bond provision was enacted in 1988 but does not come into effect until 1990. That provision was designed to encourage college savings by families with incomes of $60,000 per year or below. Such families may purchase up to $30,000 a year in these EE bonds and then, if the redemption processes are used for qualified educational expenses, they will not pay Federal income taxes on the interest earned on the savings bonds.

While we support the EE program, we would like to extend it to include a broad range of financial institutions and a much broader range of investments. The program would be structured like the IRA but in an account called the CSA—the College Savings Account. It would be available to exactly the same income bracket of families as the EE program and it would apply to the same type of qualified educational expenses.

We think that this proposal would be beneficial because it would harness the energies of the private sector to promoting college education and would make the college program much more accessible and convenient to the families who are eligible for the program. We also think that it would lower the administrative costs of the program and shift them from the public sector to the private sector.

We have spent some time working to design this proposal so that it would cost no more than the revenue estimate which was attached to the EE program and we think that this can be done with two additional restrictions on the CSA:

First, the amount of contributions per year per family could be reduced from $30,000 a year to $10,000 a year.

And second of all, there could be a 5-year holding period imposed on the CSA account while the series EE bond would still be available for families that wanted to save in a shorter period.

With these two restrictions, we believe that this program would cost no more than the Treasury estimate for the EE program.

We urge the committee to consider this proposal because it is a rare bird. It is an opportunity to promote savings without costing any more than the programs that are already on the books. We would work with the committee staff to make sure that the revenue estimates were consistent with these objectives.

My second proposal is somewhat broader and relates to the IRA. This proposal would involve some additional cost to the Federal Government but could be kept at a fairly modest level.

As the committee is aware, the 1986 Tax Reform Act restricted IRAs contributions and associated tax deductions for families with incomes over $40,000 who participated in corporate pension plans. For these people there is no front-end deduction. There is no back-end exclusion. There is only a deferral of income tax during the time the investment is in the IRA account.

As a result, the IRA participation rates have dramatically gone down. At Fidelity we have seen that in 1987 the amounts of contributions were roughly one-fourth what they were for the 1986 tax year. There is simply not enough incentive for people to lock up money for 20 or 30 years on the basis of a deferral of income tax alone.

On the other hand, we recognize that to bring back an up front deduction for IRA's would be very expensive—a 3-year estimate roughly $18 billion. So we have developed a middle ground proposal—basically to add to the deferral a back-end exclusion of the investment income so that at retirement there would be no income tax on the investment income earned on the IRA account. We believe that this double benefit, the deferral plus the back-end exclusion, we think would be sufficient to overcome the widespread lack of enthusiasm now evidenced by many people looking at the current IRA program.

It also would be designed to rebut the two major arguments against restoring the IRA program:

The first is obviously money. Because there would be no front-end exclusion and only a back-end exclusion, the cost would not be that high. According to a big eight accounting firm that we have had run the numbers, there would be a revenue loss of about $1.5 billion for 3 years, which comes to roughly $500 million per year. This is a reasonable price, we feel, to really make the IRA program work, bring it back with some vigor.

The second thing that we would achieve by having a back-end exclusion is an effective rebuttal to some of the arguments that were made earlier today that the IRA, the pre-1987 IRA, just moved savings around because people were trying to get that up front deduction. If we did not have an up front deduction, but instead had a back-end exclusion, I think we could feel a lot more certain that the moneys that were going into the IRA were being used for savings.

Therefore, we would suggest that the committee consider this type of approach to restoring the IRA. It was a popular program but it cost a lot. Our proposal is a way to encourage a lot more retirement savings at a fairly low price tag.

Thank you, Mr. Chairman.

Chairman ROSTENKOWSKI. Thank you.

[The statement of Mr. Pozen follows:]

April 19, 1989

TESTIMONY OF ROBERT C. POZEN,
GENERAL COUNSEL AND MANAGING DIRECTOR OF FIDELITY INVESTMENTS
BEFORE THE COMMITTEE ON WAYS AND MEANS,
U.S. HOUSE OF REPRESENTATIVES

Chairman Rostenkowski and Congressmen:

I am Robert C. Pozen, the General Counsel and a Managing Director of Fidelity Investments, which manages close to $90 billion of assets for over 4 million accounts. Of these assets, over $30 billion are retirement assets.

We at Fidelity Investments are very concerned about the low personal savings rate in the United States. We believe that private financial institutions can play a major role in helping to increase this savings rate.

On the other hand, we recognize that there are constraints imposed by the current budget deficit on creating new tax incentives for savings. Any such incentives need to be designed to minimize the loss of federal tax revenues.

Given this context, we believe that Congress should give serious consideration to two approaches to promoting savings:

1. Congress should give immediate attention to possible enhancements to the Series EE Savings Bond program for college savings, which was enacted in 1988 but does not take effect until 1990. As explained below, these enhancements could be designed so that they do not increase the costs of the Series EE program.

2. Congress should consider restoring the universal IRA with a tax exclusion of investment income at the time of retirement, instead of tax deductions for contributions at the time of contribution. This back-end retirement account is estimated to involve a revenue loss of only $500 million per year over a three-year period.

## 1. College Savings

As you know, last year Congress enacted a provision that allowed certain taxpayers to exclude from their income interest on U.S. Series EE Savings Bonds if the proceeds from redeeming the Bonds are used for qualified educational expenses. Each year parents may purchase Series EE Bonds with an issue price of up to $30,000 (face value of up to $60,000). There is nc minimum holding period for the exclusion of interest from these Bonds as long as the redemption proceeds are used for tuition or required fees at eligible educational institutions.

Fidelity Investments supports the Series EE program to encourage college savings. This program is limited to couples with adjusted gross annual income of $60,000 or less, with a phase-out between $60,000 and $90,000 per year. Thus, the program serves middle class families who are not eligible for most of the government guaranteed educational loans, but who cannot afford to pay college tuition out of current income.

We believe this program could be significantly enhanced if it also allowed college savings accounts ("CSAs") to be established at qualified financial institutions and the assets in CSAs to be placed in a broad array of investments. Investment income from a CSA, like interest from a Series EE Bond, would never be taxed if the assets were used for qualified educational expenses. Such a modified program would utilize the talents of the private sector to encourage college savings, thereby allowing the program to reach a broader range of eligible families.

Moreover, according to estimates by a Big Eight accounting firm, CSAs would not impose any greater costs on the federal government than the Treasury estimated costs of the Series EE program if two conditions were added. First, the annual contribution limit could be reduced from $30,000 per family to $10,000 per family. Second, a minimum holding period of 5 years could be required for CSAs, while shorter term college savings could still be invested in Series EE Bonds.

We urge this Committee to focus on these possible enhancements to the Series EE program since it becomes effective on January 1, 1990. We would be glad to provide the Committee with more detail on the proposed amendments to the Series EE program and the associated revenue estimates.

2. Retirement Savings

The principles involved in the college savings program suggest a broader possible approach to the reformulation of the IRA. The key to the proposed college savings program is that it provides not only a deferral of taxes on investment income during the holding period, but also the exclusion of investment income from taxes when the proceeds are withdrawn. A retirement savings account ("RSA") designed on these principles and available to all taxpayers would have substantial advantages over the current IRA in generating retirement savings.

As you know, front-end deductions for IRA contributions have been limited since 1987 to taxpayers who are not participants in retirement plans or who meet certain annual income limits ($40,000 or less for a couple, with a phase-out between $40,000 and $50,000). For all other taxpayers, there is neither a front-end deduction for IRA contributions nor a back-end exclusion of IRA income upon retirement. There is only a deferral of income tax on investment income earned from IRA assets until retirement.

As a result of these new tax constraints, the number of taxpayers making IRA contributions has dropped dramatically. The deferral of taxes on investment income, standing alone, has not proved to be an effective stimulant to retirement savings.

However, we believe that the combination of a tax deferral on investment income and a tax exclusion of that income upon retirement would be a much more powerful incentive to save for retirement. In our view, this combination would be sufficent to overcome the lack of enthusiasm evidenced by many families who are no longer eligible for IRA deductions.

There are two main arguments against a broad based tax incentive for retirement savings. First is cost: to restore the pre-1987 IRA would cost approximately $6 billion per year over the next three years. However, since the RSA has the back-end exclusion of investment income, rather than the front-end deduction of the IRA, the cost of the RSA would be much lower -- estimated at $500 million per year over the next three years by a Big Eight accounting firm.

The second argument is that the up-front deduction of the pre-1987 IRA allowed people to transfer existing savings into an IRA, instead of encouraging them to generate new savings. Within the last two years, however, two independent empirical studies have demonstrated that a majority of the pre-1987 contributions to IRAs constituted new savings. Even a higher percentage of contributions to the RSA would constitute new savings than the pre-1987 IRA with its upfront deductions because RSA participants would be making contributions in after-tax dollars.

Thus, we suggest that the Committee consider the possible advantages of a broad based program for retirement savings with a back-end tax exclusion for investment income. A back-end program like the RSA would provide a much more powerful incentive to the creation of new retirement savings than the current IRA, while costing only $500 million per year in lost tax revenues.

Mr. Steffens.

## STATEMENT OF JOHN L. STEFFENS, CHAIRMAN, TAX POLICY COMMITTEE, SECURITIES INDUSTRY ASSOCIATION, AND PRESIDENT AND CEO, CONSUMER MARKETS AT MERRILL LYNCH, PIERCE, FENNER & SMITH INC.

Mr. **Steffens**. Thank you, Mr. Chairman.

The Securities Industry Association appreciates the opportunity to be a participant in the search for some of the solutions to what we view as a critical problem—that is, the level of savings in America. It is certainly interesting to note the average American has a mere $1,200 in savings. That is not $1,200 a year, but $1,200 in total.

It is a direct result of the declining personal savings rate that has reached its lowest point in over four decades. Both Congress and the Nation faces some very serious problems. None, frankly, is more daunting than how to pay for some of the practical needs which affect each and every one of our citizens—maintaining our health, educating our children and providing for what is becoming an ever lengthening period in retirement. In each case, the costs are both soaring and frankly, staggering.

It costs $7,000 to $8,000 to send a child to college, even to a State college, when all the costs are considered and as Peter said before, the costs are increasing at higher than the inflation rate.

The U.S. Government spends a staggering $90 billion a year to provide medical care for the elderly and even with that, the elderly have to spend out of pocket expenses that total $1,500 to $1,600 per year.

Today there are 31 million Americans over the age of 65. By the year 2020 it will grow to be 65 million. If we assume that the cost of Medicare will triple in that period of time at the recent increase, plus the population will double, these numbers will show a sixfold increase in terms of future liabilities.

The cost is all the more dramatic when we compare it to the funds that are available. The average couple retiring in 1982 had assets of just $68,000. Most of that was in the equity in their home that had been paid off but they clearly couldn't afford to move to find alternative housing. Only $20,000 was available in liquid assets. They needed that investment income to supplement both Social Security as well as pension benefits and with life expectancy now growing after age 65 to 15 to 18 years, it is difficult to expect that their expenses would be able to cover—their assets would be able to cover those increases in expenses.

The shortfall is going to fall on the Government, which is already burdened with large deficits. Despite the efforts of the policymakers to reduce these deficits, I think that we have got to focus on the fact that the only alternative appears to be an unacceptable plunge in the standard of living.

Our low savings rate has other very significant adverse consequences. The cost of capital to the United States is some 25 to 80 percent higher than that of other competitive nations. To make up for that we have been a major importer of foreign capital. The foreign capital stock in this country now totals one and three quarters trillion dollars. In effect, we are borrowing the savings from other nations.

In fact, last year there was a $210 billion increase in foreign investment in this country, which was more than the total of individual savings and retained earnings by corporations. During this decade the investments have been nearly 5 percent of our gross national product, but the savings rate has only been 3 percent. That gap has been accounted for by foreign investment. They are purchasing some of our most productive assets and our most prestigious ones at the same time.

The savings rate in Canada, Germany, and Japan are three, four, five times higher than that of the United States and there are obviously a lot of factors that contribute to this and not all of them can be handled by the Government. But one fact stands clear: Our major competitors use their tax codes to encourage savings and investment while we penalize it, and encourage consumption. As the SIA testified before this committee last week, other industrial nations treat long term capital gains more favorably than we do and nearly all of them have eliminated the double taxation of dividends and many provide for lower tax rates or at least special exemptions on some interest income.

The sensitivity of savings and investments to tax policy has been proven in our country and individuals have responded to changes in the capital gains rate both positively as well as negatively and to the liberalization and then the tightening of the rules for individual IRA's. The potential for increased savings is frankly enormous, and if we just assume that the contributions to the IRA accounts had continued at the 1986 levels, and had grown at 10 percent, we would have seen the IRA balance in 1996 total something like $1 trillion.

For an individual, the power of routine savings and compounding is equally dramatic. Saving of just $200 per year compounded at 10 percent tax shelter would grow to be over $90,000 within the individual's 40 year working career. The average retiree that I cited earlier could have been in a much better position to withstand the fact that he may live in retirement as long as he worked throughout his career. We know that the tax incentives work. We could argue maybe about the cost, but there is no argument about the need to increase savings or, frankly, the consequences if we don't.

The lack of savings in this country is a clear formula to economic mediocrity. Our industry is prepared to work with the Government to implement both effective and cost efficient ways to increase savings. We are ready to promote that and to educate our customers and to make it successful. Let's begin today.

Thank you very much.

Chairman ROSTENKOWSKI. Thank you.

[The statement of Mr. Steffens follows:]

# STATEMENT OF THE
# SECURITIES INDUSTRY ASSOCIATION
# TO THE COMMITTEE
# ON WAYS & MEANS
# U.S. HOUSE OF REPRESENTATIVES
April 19, 1989

Mr. Chairman and members of the committee, I am John L. Steffens, President & Chief Executive Officer, Consumer Markets at Merrill Lynch, Pierce, Fenner & Smith Incorporated. I also serve as chairman of the Securities Industry Assocation's (SIA) Tax Policy Committee. SIA appreciates the opportunity to comment on trends in U.S. savings and investment and implications for future economic growth.

SIA represents about 585 securities firms headquartered throughout the United States and Canada. Its members include securities organizations of virtually all types -- investment banks, brokers, dealers and mutual fund companies as well as other firms functioning on the floors of the exchanges. SIA members are active in all exchange markets, in the over-the-counter market and in all phases of corporate and public finance. Collectively, they provide investors with a full spectrum of securities and investment services and account for approximately 90% of the securities business being done in North America. Because of their role in the capital markets, SIA members are in a unique position to recognize the impact of tax policy on savings and investment and the financial decisions of corporations and investors.

## Role of Savings and Investment In the Economy

In recent years, the personal savings rate in the U.S. has been on a downward slide to the lowest levels in three decades. In and of itself, this trend is cause enough for concern. Savings fuel investment, which provides the capital necessary for economic expansion and, ultimately, for increases in the U.S. standard of living. Because our major competitors have double-digit saving rates, the meager U.S. savings rate is all the more disturbing. The end result is a formula for decreasing U.S. economic competitiveness.

The savings rate was under 5% in the past four years and was at a paltry 3.2% in 1987, the lowest rate since 1947. By comparison, in the 1980-1987 period, the Japanese had a personal savings rate averaging 16.8% and the West Germans, 12.3%. A high rate of savings and investment translates to productivity gains and economic growth through higher fixed investment. The ratio of gross fixed investment to GNP averaged over 20% in Japan and Germany in the 1980 - 1987 period, while that in the U.S. averaged about 15.5%. Low personal savings rates in the U.S. combined with government deficits will damage future investment, productivity gains and international competitiveness.

Personal savings is a far more important component of national savings than a cursory glance at statistics suggests. In 1987, gross personal savings amounted to $104.2 billion, just about matching total government dissavings. Business appears to be the major saver, with gross savings amounting to $561.1 billion. However, much of business saving stems from depreciation on plant and equipment. The major component of business savings, undistributed profits, is in fact smaller than personal savings. In the early 1970s, personal savings equaled almost one half of gross business savings, a marked contrast to today's 19%.

There are other ways to measure savings in the U.S. For example, net national savings, which makes several adjustments to the gross savings data, is frequently used to compare savings to GNP. In the 1970-1979 period, net national savings was 7.2% of GNP. By 1988, that proportion had declined to a low 2.8%. Whichever measure of savings is used -- the trend is downward.

Low national savings is traceable to both the federal deficit and a drop in personal savings. Nevertheless, wherever the blame may fall, the combined effect poses serious threats to the economic health of the U.S. Productivity gains are necessary to compete internationally and to keep up the U.S. standard of living. These gains are made possible through investment in new technology, research, new plant and equipment, which are in turn financed through savings. Moreover, through the very process of investment, new investment techniques and potential products are discovered. Michael Boskin has observed: the rate of investment itself can influence the rate of technical change in a society.

Without the national savings necessary to fund investment, the U.S. has become an importer of foreign capital. The level of investment in the U.S. would have been even lower if not for foreign capital. Foreign investment accounted for the difference between savings of 3% of GNP in the current decade and investment of about 4.8%. The U.S. has, in effect, borrowed the savings of other countries. The price to pay for our borrowing could eventually be the transfer of U.S. wealth to other nations.

While national savings has been sinking, record mounds of debt have been built by the government and private sectors. Domestic government debt has ballooned from about $1 trillion in 1980 to about $2.7 trillion as a result of a string of annual budget deficits. The national debt is estimated to cross the $3 trillion mark by 1992. U.S. foreign debt is around $500 billion, compared to a positive balance of about $150 billion in 1980. During this same period, the debt of U.S. non-financial companies has grown dramatically, while equity capital has shrunk by more than $400 billion in just the last five years.

Reduced investment and foreign financing of a large fraction of what investment does take place will erode the U.S. living standard. While not an overnight occurrence, there is a relationship over time between national saving rates and rates of growth. The U.S. is still a wealthy nation, and a high rate of consumption can be financed by selling off assets for a time - but not forever. Unless our national savings rate is restored to at least its former levels (around 7%), it is possible that the U.S. will slip further relative to the size of the world economy.

Personal savings is a crucial component of the investment process and also the pool from which individuals fund future needs. Traditionally, the "rainy day" for which individuals saved was retirement and old age. Sharp increases in social security benefits as well as the expansion of medicare have eased worries over economic welfare in old age. Most of the best academic research suggests that the decline in private savings may well be permanent as it is the result of an enormous expansion in the wealth of older age groups.1/

Among the other reasons cited have been greater company-provided health and retirement benefits, easier credit availability, and widespread life insurance coverage. So too, the rapid rise in the value of housing since the mid-1970s and the bull market of the 1980s have contributed to a general illusion of wealth. In other words, the very improvement in the standard of living that Americans now enjoy, wrought in part by past savings, seems to be diminishing the propensity to continue to save.

There is a school of thought that pins their hopes on improvement in the personal savings rate on the aging of the "baby boomers." The 75 million "boomers" are entering the age where greater savings normally takes place. In addition, the curb on the deductibility of personal interest payments and insecurity about the long-term health of the social security system is expected to increase personal savings. To date,

---

1/"The Savings Slump: No Easy Solution," Wall Street Journal, 12/19/88.

there has been little evidence of this.[2] However, looming on the horizon, demographic trends and increasing life expectancy indicate that individuals will need a significant pool of savings to enjoy future years. Today, at age 65, the average life expectancy is 25% more than it was in the 1930s. By 2025, the over-65 population will double. Moreover, individuals expect far more from their retirement years than ever before.

Whatever the reason for the loss of personal savings discipline, an increase in the savings rate is key to a higher rate of economic growth and a faster rise in our standard of living. When we look beyond short-term cyclical fluctuations to consider experience over the long term, the evidence is overwhelming that countries with high rates of savings and investment are the ones in which productivity, income and standards of living rise most rapidly.[3]

## International Comparison of Economic Measures

A comparison of economic measures in the U.S. with those of its major international competitors indicates that the U.S. must be better prepared to meet future challenges. Further erosion in measures of U.S. economic health will mean further slippage for the U.S. in the global economy.

First, the comparison of savings indicators among countries is filled with pitfalls related to sociological and institutional differences. For example, the comparatively high level of U.S. incentives for home ownership means that Americans do not need to save as much as citizens of other countries in order to buy a house. Other countries may provide no incentives for the purchase of private housing. Indeed, the typical U.S. housing environment is much larger and better than what is available in other nations.

When comparing the U.S. savings rate to that of Japan, other factors enter the picture, such as the high cost of housing in Japan and the demographics trends of the Japanese population. One study found that the low ratio of older to working-age individuals explained 90% of the gap between Japanese and U.S. savings. Nevertheless, "...after adjustments of every conceivable kind, what stands out in cross-sectional surveys is the low level of the U.S. savings rate and the high level of the Japanese savings rate."[4] Other studies have noted similar results.

While direct comparisons are hazardous, trends in savings and investment can be confidently compared. When comparing U.S. saving rates to those of other countries, the picture which emerges is as disturbing as the downward trend of the U.S. rate itself. The savings rates of other countries show a similar declining trend, albeit to a much lesser extent. For example, the U.S. savings rate in 1987 was 2.5 times lower than the average U.S. savings rate in the 1970s. However, Japan and Germany saw their savings rate decline by a factor of only 1.2 and 1.1 times, respectively. Nevertheless, of the five major countries to which the U.S. savings rate is compared, four had rates which exceeded the U.S. by a *minimum* of 3 times.

Low U.S. savings has fortunately, at least until now, been bolstered by foreign capital inflows, which help to sustain investment. Clearly, there is no guarantee these inflows will continue. Of note, savings rates in other countries are generally closer to that of Japan than to the U.S. Put in another perspective, the problem is that the U.S. saves too little rather than the rest of the world saves too much!

---

[2] Unpublished working paper, Irv Levenson, Marshall and McLennan.

[3] "A National Savings President," Martin Feldstein, *Wall Street Journal*, 11/21/88.

[4] "*Saving Rates in Japan and the United States: The Roles of Tax Policy and Other Factors*," John H. Makin, 1985.

**Table I**

**Ratio of Foreign to U.S. Savings Rate**
(Households)

| Country | Foreign/ U.S. |
|---|---|
| Japan | 5.1X |
| Germany | 3.8 |
| France | 3.7 |
| Canada | 2.9 |
| U.K. | 1.6 |

Similarly, in terms of gross fixed capital formation, the U.S. also has lagged behind its major trading partners. While a comparison of 1972 to 1987 indicates that the U.S. has seemingly declined the least, two points might be made. First, the U.S. ratio is still well below that of the other countries. Second, Canada, Japan, France and the U.K. experienced increases in this ratio in 1987.

A reason for the divergence in trends in capital formation cannot be pinpointed. However, it may in part be explained by the cost of capital. Lower national savings leads to reduced investment because, by its scarcity, the cost of capital is raised. Even before the Tax Reform Act of 1986, the cost of capital in the U.S. was higher than in several of our major foreign competitors. A 1983 study by the International Trade Commission estimated that the cost of capital for U.S. companies was about 16.6%, compared to about 9% for Japanese and West German companies. Higher taxes on capital and investment contribute to differences in the cost of capital between the U.S. and some foreign countries. This differential puts U.S. firms at a competitive disadvantage in the evolving global economy. Increased savings and lower capital cost would improve the ability of U.S. firms to attract equity capital and to compete successfully on the international level.

Savings and investment also affect trade balances. Japan had a trade deficit as recently as 1981, and Germany ran a deficit in 1982. Until very recently, both countries have enjoyed increasingly hefty surpluses. The U.S., in contrast, has been in exactly the reverse position. The U.S. maintained a trade surplus until 1982, since then deficits have increasingly been a larger percentage of GNP. The turnabout of the deficits in Japan and Germany are not easily explained, nor is the reverse situation for the U.S. However, we believe that the differences in savings and investment in these countries explain why Germany and Japan are now in strong competitive positions, and the U. S. trade position is precarious, to say the least.

Another indicator of the gain our foreign competitors have made in recent years can be measured by equity market capitalization -- the premier position of the U.S. has been lost. In 1980, the U.S. held 50% of the total market capitalization of all exchanges. Even at year-end 1985, the U.S. still claimed a 49% share of world stock markets. The Tokyo Stock Exchange has surpassed the New York Stock Exchange as the world's largest market. Moreover, the U.S. share of world market capitalization has dwindled sharply. By year-end 1988, the U.S. share of world equity markets plummetted to a mere 30%. Obviously, the U.S. no longer has a monoply in terms of attracting investors. The 67% increase in the size of the U.S. market from $1.2 trillion in 1980 to about $2 trillion by year-end 1988 was outpaced by the 160% gain in markets around the world.

## International Comparisons of the Tax Treatment of Investment Income

A more favorable tax treatment of investment income by foreign countries than in the U.S., in part, has fostered higher levels of savings and investment. It is indeed ironic that while the U.S. can claim among the lowest rates on wage and salary income, it can also claim among the highest rates on investment income. Across-the-board, the U.S. falls behind its major competitors in the tax treatment on the return from savings -- dividends, interest, and capital gains. In almost all foreign countries, tax incentives are used to stimulate savings and investment.

### Dividend Income

The double tax burden on the current return on equity investment has been recognized by our foreign competitors. Through integration of the corporate and individual tax or special allowances and exemptions, most major foreign countries have acted to mitigate the double tax. Of ten major industrialized countries, seven have a form of integration. Moreover, of these seven countries, five -- France, Germany, Italy, Japan and the U.K. -- also have special allowances and exemptions to encourage equity investment.

### Interest Income

Similarly, four of ten major foreign countries generally apply tax rates lower than in the U.S. on interest income. Of note, Japan has the lowest rate, 15%, on the investments reviewed. In addition, while some countries have rates higher than the U.S. and some have exempted instruments equivalent to municipal obligations, other savings incentives are also provided. For example, interest on 5-year savings accounts of a maximum of $11,759 is tax exempt in Sweden.

Table II

Summary of Individual Taxation of Interest Income

| Countries | National Government Bonds | Corp. Bonds | Savings Acconts | Other Interest | Special Allowances Or Exemptions |
|---|---|---|---|---|---|
| United States | 33% | 33% | 33% | 33% | Exemption (A) |
| Australia | 50.25% | 50.25% | 50.25% | 50.25% | None |
| Belgium | 25% | 25% | 25% | 25% | None |
| Canada | 29% | 29% | 29% | 29% | None |
| France | 56.8% | 56.8% | 56.8% | 56.8% | Exemption (B) |
| Germany | 56% | 56% | 56% | 56% | Exemption (C) |
| Italy | 12.5% | 12.5% | 30% | 50% | Exemption (D) |
| Japan | 15% | 15% | 15% | 15% | Exemption (E) |
| Netherlands | 72% | 72% | 72% | 72% | Exemption (F) |
| Sweden | 42% | 42% | 42% | 42% | Exemption (G) |
| United Kingdom | 40% | 40% | 20% | 40% | Exemption (H) |
| Hong Kong | Exempt | Exempt | Exempt | Exempt | None |
| Indonesia | 35% | 35% | 15% | 35% | None |
| Malaysia | Exempt | 45% | 5% | 40% | Exemption (I) |
| Singapore | Exempt | Exempt | Exempt | Exempt | None |
| South Korea | 10% | 10% | 10% | 25% | None |
| Taiwan | 50% | 50% | 50% | 50% | Deduction (J) |

---

Note: This is a summary of the preliminary results of a study by SIA/Spicer Oppenheim to be completed in June. Details will be provided on special situations affecting the taxation of interest income in the final study. Conversion of exchange rates as of 4/10/89. State, local and provincial taxes not included.

(A) Interest from state and local obligations is tax exempt.
(B) Interest on certain savings accounts is tax exempt. Elected withholding at the source results in 27%, and 47% rate on savings account. Annual rate on bonds interest (or dividend) exemption.
(C) Interest on certain long-term government bonds exempt.
(D) Certain bonds are tax exempt or taxed at lower rates.
(E) Interest on certain employee savings accounts exempt.
(F) Annual exemption of $944/$472 (DFL 2,000/DFL 1,000) for married/single taxpayers.
(G) Certain savings accounts for a 5-year term are exempt. The maximum account is $11,,759 (SEK 75,000).
(H) Interest on National Savings Certificates is exempt.
(I) Interest on savings accounts of up to $1,832 (M $5,000) is exempt. Interest on fixed deposits held for at least 12 months with the National Bank is tax exempt.
(J) Special deduction of up to $13,153 (NTD 360,000) can be offset against interest (or dividends) from certain types of savings and investment.

## Table III

### Summary of Individual Taxation of Dividend Income

| Countries | Integration of Corporation/ Shareholder Taxation | Maximum Marginal Tax Rates on Dividends | Special Allowances Or Exemptions Other Than Integration |
|---|---|---|---|
| United States | No | 33% | None |
| Australia | Yes | 50.25% | None |
| Belgium | No | 25% | None |
| Canada | Yes | 29% | None |
| France | Yes | 56.8% | Annual Exemption (A) |
| Germany | Yes | 56% | Annual Exemption (B) |
| Italy | Yes | 50% | Special Allowance (C) |
| Japan | Yes | 35% | Annual Tax Credit (D) |
| Netherlands | No | 72% | Annual Exemption (E) |
| Sweden | No | 42% | Annual Deduction (F) |
| United Kingdom | Yes | 40% | Special Allowance (G) |
| Hong Kong | NA | NA | NA |
| Indonesia | No | 35% | None |
| Malaysia | Yes | 45% | None |
| Singapore | Yes | None | None |
| South Korea | Yes | 25% | Special Allowances (H) |
| Taiwan | No | 50% | Annual Exemption (I) |

---

Note: This is a summary of the preliminary results of a study by SIA/Spicer Oppenheim to be completed in June. Details will be provided on methods of integration and special situations affecting the taxation of dividend income in the final study. Conversion of exchange rates as of 4/10/89. State, local and provincial taxes not included. NA - Not available.

(A) Annual dividend (or interest) exemption of $2,526/$1,263 (FF 16,000/FF 8,000) for married single taxpayers.
(B) Annual dividend (or interest) exemption of $321/$160 (DM 600/DM 300) for married/single taxpayers.
(C) Special savings stock similar to preferred but without liquidation preferences taxed at 15% rate at the source.
(D) Annual tax credit of 10% of dividend income up to $75,700 (Yen 10 million) and 5% for the excess over that amount.
(E) Annual exemption of $947/$473 (DFL 2000/DFL 1,000) for married/single taxpayers. Special $473 (DFL 1,000) exemption for dividends for recognized venture capital company.
(F) Annual deduction of $257 (SEK 1,600) per person.
(G) Tax exemption for dividends on personal equity plans.
(H) A 10% maximum tax applies to dividends on (1) stock exchange listed shares, (2) certain agricultural, fishing and livestock companies and (3) employee shareholders of non-listed stock.
(I) Annual exemption of $13,338 (NTD 360,000) for listed companies dividends.

## Capital Gains

Compared with the six countries taxing long-term gains, the U.S. treatment of capital gains is among the harshest of the major industrialized countries. Canada, France and Sweden tax long-term capital gains at rates ranging from 16% to under 20%. While Australia and the U.K. have higher statutory long-term capital gains tax rates than the U.S., substantial exemptions and indexing of the cost basis result in more favorable tax treatment of capital gains than in the U.S. Japan plans tax reform in 1989, which will give investors a choice of a 1% gross proceeds tax or a 20% net capital gains tax.

In one of the fastest growing areas of the world, capital gains are exempt from taxation by most countries. Hong Kong and four of five Pacific Basin countries do not tax capital gains. Indonesia taxes both long- and short-term gain at a rate of 35%. However, for long-term gain on securities, the effective rate varies depending on several factors but is lower than 35%.

## Table IV

### Summary of Individual Taxation of Capital Gains on Portfolio Stock Investment

| Countries | Maximum Short-Term Cap. Gain Tax Rate | Maximum Long-Term Cap. Gain Tax Rate | Period to Determine Short- Or Long-Term Gain | Maximum Annual Net Worth Tax Rate |
|---|---|---|---|---|
| United States | 33% | 33% | One Year | None |
| Australia(A) | 50.25% | 50.25% | One Year | None |
| Belgium | Exempt | Exempt | None | None |
| Canada(B) | 19.33% | 19.33% | None | None |
| France(C) | 16% | 16% | None | 1.1% |
| Germany(D) | 56% | Exempt | Six Months | .5% |
| Italy | Exempt | Exempt | None | None |
| Japan(E) | 20% | 20% | None | None |
| Netherlands | Exempt | Exempt | None | .8% |
| Sweden(F) | 42% | 16.8% | Two Years | 3% |
| United Kingdom(G) | 40% | 40% | None | None |
| Hong Kong | Exempt | Exempt | None | None |
| Indonesia(I) | 35% | 35% | One Year | None |
| Malaysia | Exempt | Exempt | None | None |
| Singapore | Exempt | Exempt | None | None |
| South Korea | Exempt | Exempt | None | None |
| Taiwan(J) | Exempt | Exempt | One Year | None |

---

Note: This is a summary of the preliminary results of a study by SIA/Spicer Oppenheim to be completed in June. Details will be provided on special situations affecting the taxation of capital gains in the final study. Conversion of exchange rates as of 4/7/89. State, local and provincial taxes not included.

(A) Long-term capital gains from assets acquired prior to 9/20/85 is tax exempt and cost basis of other assets held more than 1 year is indexed for inflation.
(B) Lifetime cumulative capital gain exemption of $83,857 (Canadian $100,000); $419,287 (Canadian $500,000) for gain on sale of shares in small business.
(C) Exemption for capital gains or sale proceeds of up to $45,518 (FF 288,400).
(D) First $533 (DM 1,000) of short-term gain is exempt annually.
(E) Effective 4/1/89, capital gains tax on sale of stocks or securities. Previously, gain was exempt.
(F) A 60% exclusion for long-term gain produces lower long-term rate.
(G) First $8,480 (5,000 pounds) of gain is exempt annually.
(I) For securities held more than 1 year, gain is taxed at an average effective rate which varies depending on several factors, but is generally lower than 35%.
(J) During 1989, the following are tax exempt: (1) all gain from the sale of stock acquired before 1989 (2) up to $366,300 (NT $10,000,000) of gain on stock acquired after 1988, and (3) 50% of the gain on unlisted securities held for more than one year. If these exemptions do not apply, the individual is subject to national income tax at a maximum rate of up to 50%.

## Improving U.S. Savings

The federal deficit is the major drain on the savings generated by other sectors. Reducing the deficit is the most potent solution for the dismal national savings rate. Despite the efforts of policymakers, the outlook remains one of large and continuing deficits.

Beyond deficit reduction, improving personal savings can begin to arrest the slide in the national savings rate. Policymakers are somewhat limited in the savings incentives that can be created, but the tax code offers a starting point. In an ideal system for encouraging savings, income saved would be tax exempt and one-step removed from the ideal, the return on savings would be tax exempt. Barring the ideal, improving the after-tax return on savings through targeted tax incentives is one way to influence the savings decisions of not only individuals but corporate investors as well.

The trend in the 1980s, however, has been to eliminate targeted savings and investment tax incentives -- IRAs for most individuals, the dividend exclusion and the capital gains exclusion. The Tax Reform Act of 1986 eliminated all targeted incentives for individual equity investment. All savings and investment income -- interest, dividends and capital gains -- is on equal tax footing with other income sources.

Of particular note, the decline in personal savings should not be taken as evidence that IRAs and capital gains exclusions did not have a substantial effect on savings decisions. Many other factors may have lowered the savings rate, obscuring the positive effect of saving tax incentives. Without targeted incentives, the savings rate may fall further. The taxtreatment of investment income and the IRA experience merit review and reconsideration.

## Capital Gains Treatment

The 1986 tax act contained the largest increase in capital gains taxes in history; a 65% increase for investors in the top tax bracket and an even greater increase for some middle income investors. Prior to 1987, the taxation of inflationary gains, the double taxation of corporate income, and the capital loss limitation -- factors that can act to deter investment -- were mitigated by the capital gains exclusion. Thus, the elimination of the exclusion added a heavy weight to the bias against long-term equity investment.

The 1978 and 1981 capital gains tax cuts are a documented success story. Individuals reacted by suppling increased amounts of capital for equity investment, particularly for those small companies that create jobs and new technology. Moreover, tax revenues were raised, not lost, for Treasury. But, the significant economic consequences of lower capital gains taxes are worthwhile even if revenues are not raised. (See SIA Statement to this Committee, April 13, 1989.)

## IRAs/401(k) Plans

Similar to preferential treatment of capital gains, Individual Retirement Accounts (IRAs) are an example of a targeted tax incentive of the 1980s which was tried, proven successful, and weakened or eliminated. In 1982, with the liberalization of IRA requirements, these accounts were claimed on 12 million returns, bringing about $28.3 billion in savings. By 1986, over 15 million returns showed IRA contributions of over $37 billion. The 1986 tax act curtailed the tax deductibility of IRA investment for most individuals. In 1987, with the limited availability of the IRA tax deduction, only 7.4 million returns claimed IRAs and the amount of funds saved in these accounts shrunk 62% only to $14.1 billion. Clearly, the tax deductibility of IRA contributions was a powerful incentive which generated significant savings.

### Table V

### Individual Retirement Arrangements Adjustments to Income
($ in Billions)

| Year | Number of Returns | Amount |
|---|---|---|
| 1980 | 2,564,421 | $3.4 |
| 1981 | 3,415,053 | 4.8 |
| 1982 | 12,010,038 | 28.3 |
| 1983 | 13,613,167 | 32.1 |
| 1984 | 15,232,856 | 35.4 |
| 1985 | 16,205,846 | 38.2 |
| 1986 | 15,535,531 | 37.8 |
| 1987P | 7,351,364 | 14.1 |

Source: Statistics of Income Bulletins

While a review of statistics shows that individuals did indeed respond to the IRA tax incentive, much controversy has surrounded the origin of IRA funds -- new savings or the shift of other assets. Included in the IRA literature is a series of studies by Steven F. Venti and David A. Wise for the National Bureau of Economic Research. Three of the main conclusions drawn from their analysis are: 1. IRAs had a substantial positive net effect on personal savings; 2. Two-thirds of the families that contributed to IRAs had annual income of less than $50,000; and 3. IRAs did not merely substitute for other forms of retirement savings.

The actual data plus a growing pool of academic research conclude that IRAs were a powerful savings incentive. In addition, an often unrecognized benefit of IRA-type incentives is psychological. Through the very advertising that firms engage in to attract IRA accounts, individuals may focus more on the need to save.[5] For tax year 1984, about one-half of IRA contributions were made in 1985. This "last minute" response suggests that the stepped-up IRA advertising also stepped-up individuals' awareness of this savings incentive and sensitivity to tax policy.

Research by Chris Carroll and Lawrence Summers comparing the divergence of the U.S. and Canadian savings rate makes some striking observations on the long-term importance of savings incentives. The Canadian and U.S. private savings rate moved in tandem for almost 25 years. In 1972, Canada initiated a retirement savings program, similar to but more generous than the U.S. IRA program, and subsequently liberalized the program in 1976. After 1976, the Canadian savings rate began a climb which pushed it significantly above the U.S. rate.

Section 401(k) plans have had expolsive growth during the past decade. The combined assets of these plans exceeded $70 billion by 1986. In that year alone, employees contributed $6.4 billion and employers added $2.4 billion, according to the Employee Benefit Research Institute. Most of these plans offer a combined appeal for saving: a tax incentive from the government, a "matching" payment from the employer, and the ease and convenience of an automatic payroll deduction.

It is too soon to quantify the dampening effect that the 1986 restrictions on these plans may have had. Some plans have been cancelled, and some funds previously contributed have undoubtedly been diverted from savings. No reliable data measuring these effects has yet been developed.

Like IRAs, however, withdrawals from a 401(k) plan prior to retirement may been subject to an additional penalty tax. Particularly for younger employees, this may serve as a disincentive to investment. Those employees have other more immediate, though still long-range, savings goals; i.e., the purchase of a home or the education of children.

## Special Allowances and Exemptions

Special allowances and exemptions are widely used by many foreign nations to spur individual savings and investment. The following is a sampling of the special provisions used by other countries in the treatment of investment income.

Capital Gains: Canada has a lifetime exemption of $83,857 and a larger exemption for proceeds from sale of shares of small business. France excludes capital gains on sale proceeds of up to $45,518.

Dividend Income: One of the most widely recognized inequities in the taxation of return from investment is the double tax on dividend income. In the U.S., corporate dividends paid to shareholders are subject to a maximum 56% effective tax rate. Most major countries use an integrated system as well as exemptions and deductions for dividend income. The Netherlands has an annual exemption of $947/$473, while the U.K. exempts dividends for personal equity plans.

Interest Income: Singapore appears to exempt completely interest on fixed income investment. Several countries offer tax exemption for the interest return on certain investments held for a specific period of time; i.e., five years in Sweden. In the U.K., the interest return on a National Savings Account is tax free.

---

[5] "The Budget Deficit Problem: 1989" by Lawrence H. Summers, Tax Notes, 3/6/89.

## Summary

Tax incentives can and have stimulated individual savings and investment. The U.S. cannot afford to wait to encourage savings. An aging population and increasing competitive

challenges do not allow room for error in calculating future savings and investment needs. Savings and investment fund future economic growth. A full range of tax options -- already tested and proven -- could ensure a strong and healthy future for the U.S.

Chairman **Rostenkowski**. Are there any questions of this panel?

If not, gentlemen, thank you very much for participating in this discussion.

The committee will stand in recess until 2 o'clock this afternoon at which time we have one panel to discuss this issue and the Congressional Budget Office.

[Whereupon, at 12:20 p.m., the committee was recessed, to reconvene at 2 p.m.]

### AFTERNOON SESSION

Chairman **Rostenkowski**. The committee will come to order.

This afternoon the committee will continue to receive testimony on long-term strategies. These hearings are not focused on proposed, pending or potential legislation. Rather, we are stepping out of the immediate legislative process so we can look objectively at some of the long-run issues that confront this committee and the Nation.

This morning we heard that our low national savings rate could have serious implications for the future. Americans continue to spend more and save less. In order to slow consumption and boost savings, we may have to provide additional incentives for Americans, particularly Americans who have the capability to lower consumption and raise their savings rate.

While we consider this situation, its implications and ways of alleviating the problem, I also would like to bring to the attention of the committee the growing gap in our income distribution. A number of studies have been published recently that lead to the conclusion that the gap between the rich and the poor continues to grow.

Other members of this committee may be surprised, as I was, by the data describing income inequity. Despite our unprecedented period of economic expansion and despite the number of Government assistance programs we have directed toward the poor, the poorest 20 percent of Americans, particularly poor families with children, have experienced a significant decrease in income over the last 15 years.

The CBO did a comprehensive study of recent trends in income and tax burden distributions that was included in this year's Green Book. The committee has asked Bob Reischauer, director of CBO, to present the data from this study to the committee, to suggest reasons for this growing inequity and its implications for our country.

Dr. Reischauer, welcome to the committee, and we are looking forward to your testimony.

## STATEMENT OF HON. ROBERT D. REISCHAUER, PH.D., DIRECTOR, CONGRESSIONAL BUDGET OFFICE

Mr. **Reischauer**. Thank you, Mr. Chairman. I certainly appreciate the opportunity to appear today before the committee to discuss CBO findings with respect to the level and distribution of income and tax liabilities, and how these have changed over the last few years. I will submit my prepared statement for the record.

Chairman **Rostenkowski**. Without objection, your entire testimony will be submitted into the record.

Mr. REISCHAUER. I will briefly summarize CBO's findings with respect to three questions: How much have family incomes changed over the last decade and a half; second, has the distribution of income become more or less equal over this period? And third, what has happened to effective Federal tax rates and the distribution of Federal taxes in recent years?

The answer to the first question is that average adjusted family income—and by that I mean income adjusted for both family size and inflation—has grown by about 17 percent over the past decade and a half.

As the bottom panel of the first figure in the handout shows, families of all types have experienced this growth of income. However, the gains vary widely among different family types. In particular, the elderly experienced greater increases, while single mothers and their children have had the smallest gains.

What factors have contributed to this pattern of unequal growth? Obviously it is a complex situation, but one thing that has played a role is increased labor force participation. The average nonelderly family had more members in the work force in 1987 than did similar families in 1973.

A second factor was the increase that women experienced in their real earnings.

A third factor was the decline in the average size of families with children. Because the average family of this type had fewer members to support in 1987 than in 1973, it would have experienced a rising standard of living even if its real income had not increased at all.

The final factor that has contributed to the rise of incomes was a substantial improvement in the situation of the elderly, much of which was attributable to the rapid increase in the real value of the average Social Security benefit received by the elderly.

What about the second question, which dealt with inequality? While average incomes rose over this period, the distribution of income among all families became more unequal between 1973 and 1987. The average adjusted family income fell for the poorest fifth of the population and rose for the other four-fifths. The rise was particularly pronounced for the highest income groups.

Much of this increase was related to demographic shifts, particularly the growth in the fraction of the population consisting of nonelderly, unrelated individuals.

The second figure isolates the shifts by showing the patterns experienced by different family types. The top two panels show large gains for high-income families with children and sharp declines for those with low incomes. Other groups had smaller changes in their income situation and the elderly showed no particular pattern of rising or falling income inequality.

The third figure in the handout splits the 1973 to 1987 period into two sub-periods. This partitioning reveals that the increase in income inequality occurred largely between 1979 and 1987. Adjusted incomes of families in the bottom quintiles were markedly lower in 1987 than the incomes of corresponding quintiles in 1979, while the highest quintiles had large income gains shown by the dark bars in the third figure. For single mothers, this period was particularly bad.

Why was there this increase in inequality during the 1979 to 1987 period? This is a difficult question for which we don't have definitive answers. But we do know that the income growth was greater for the top quintile in part because of increases in labor force participation, which I mentioned earlier.

These increases occurred largely among high-income families. While high-income families on the average had more workers in each family in 1987 than in 1973, this was not true for the low-income families.

The changing pattern of educational attainment was also a factor here, but it had two offsetting effects. First, the income disparity among workers with different amounts of education grew over this period, thus increasing inequality; that is, there was an increase in the premium provided a person with a college education versus one with only a high school education, or one with not even a high school education. This growth should have increased inequality but it was offset by higher average levels of education. We had a rising fraction of the population with college degrees and with high school degrees and a shrinking fraction of the work force that had more limited amounts of education.

Uneven changes in benefit levels for programs that help low-income families helped to increase inequality. AFDC benefits declined over the period, thus reducing the incomes of low-income, female-headed families in particular, while the benefit levels in the SSI program increased, making the poorest of the elderly better off than their counterparts were a decade and a half earlier.

Let me turn to the question of whether changes in the Federal tax system since the mid 1970's have ameliorated or exacerbated inequality. The top panel of the fourth figure in the handout shows effective Federal tax rates—I mean the percent of income paid in taxes for people ranked in quintiles by their adjusted pretax income for 1977, 1980, 1985 and 1990.

In 1990, the effective tax rate for the one-fifth of people in families with the highest incomes will be slightly less than it was in 1977 or 1980, and you can see this by comparing the 26.8 percent figure with the 27.1 and 27.3 percent for 1977 and 1980.

The effective tax rates for people in the remaining four quintiles will be higher. Although Federal taxes in 1990 will be less progressive than they were in 1977 or 1980, it should be pointed out that they will be more progressive than they were in 1985.

What has caused the tax system to become less progressive than it was a decade ago? The top panel of the fifth figure shows that it is not because the individual income tax has become significantly less progressive.

Effective income tax rates are projected to be quite similar in 1990 to what they were in 1977. The exception to this is for people in the lowest quintile whose effective tax rates will fall by about 1 percentage point. The rates were slightly negative in 1977, and they will become more negative in 1990.

The individual income tax did become less progressive between 1977 and 1985, as rising incomes pushed families into higher tax brackets. The tax cuts of ERTA offset this change for high-income families, but not for low-income families.

Recent changes in tax law, especially the Tax Reform Act of 1986, will make the individual income tax more progressive in 1990 than it was in 1985, and thus restore 1990 effective tax rates to about the levels that existed in 1977.

A major factor in reducing the progressivity of the Federal tax system is the increased reliance we have placed on social insurance payroll taxes. While individual income taxes are projected to remain roughly constant as a share of income, 11.1 percent in 1977 and 1990, the share of income paid in social insurance taxes is projected to be higher, rising from 6.5 to 8.8 percent over the 1977 to 1990 period.

The last figure in the handout shows that in 1990, effective income tax rates will rise sharply with income, while social insurance tax rates will rise more slowly and then drop, for the 20 percent of the people in the highest quintile.

By 1990, people in the bottom 80 percent of the income distribution will pay more in social insurance taxes than they do in income taxes. In 1980, only people in the bottom half of the income distribution paid more in social insurance taxes than they paid in income taxes.

What relevance does this information have for the changing saving rate in the United States? Can any of the decline in national saving be traced back to changes that have taken place in the distribution of income? I think the answer is a clear "no."

Most economists believe that upper income groups have a greater propensity to save than lower income groups. To the extent that this is true, the increase in income inequality that has occurred over the past decade and a half, taken by itself, should have increased household saving. The fact that the saving rate has fallen suggests that other factors have overwhelmed any impact that income inequality might have had.

Finally, I would like to talk about a different subject for the moment, and that is to commend the committee for publishing the 1989 edition of the Green Book. In my former life, I found this volume to be the most valuable source of information on Federal programs.

I know that my opinion is shared by scholars in universities and think tanks and by policy experts who work for both public and private interest groups here and around the country. All of us have come to rely on the Green Book as a source of comprehensive and useful information about the programs that are before this committee. You do a tremendous service in helping the American people understand Federal programs by publishing this volume every year.

Thank you.

[The statement of Mr. Reischauer follows:]

## STATEMENT OF ROBERT D. REISCHAUER, DIRECTOR CONGRESSIONAL BUDGET OFFICE

Mr. Chairman, I appreciate the opportunity to appear today before this Committee to summarize the Congressional Budget Office's (CBO's) work on trends in the level and distribution of income and tax liabilities.[1] My statement addresses three questions:

- o How much have family incomes grown over the past decade and one-half?
- o Has the distribution of income become more or less equal over this period? and
- o What has happened to effective federal tax rates and the distribution of federal taxes in recent years?

Questions such as these appear to be simple and straightforward, but to answer them one must resolve a number of complex conceptual and methodological issues. For example, decisions must be made about how to define and measure income, how to adjust it for inflation, how to make incomes of families of different sizes comparable, and what period of time to examine.

CBO's analysis of income trends and changes in the distribution of income uses the adjusted family income (AFI) measure, which is equal to a family's cash income as reported in the Current Population Survey (CPS), divided by its poverty threshold. Adjusted family income is measured before taxes and excludes, because data are not available, income from capital gains and in-kind income such as health insurance provided by employers or governments.[2]

Incomes for the entire 1973-1987 period examined here are adjusted for inflation using the methodology on which the Consumer Price Index (CPI) is currently based, often called the CPI-X1.[3] The incomes of families of different size are made comparable by dividing each family's income by its poverty threshold. Under this approach, we regard a four-person family with an income of $34,800 in 1987--or three times the poverty threshold for that size family--as being on a par with a three-person family with an income of $27,200, which is three times the poverty level for that size family. Single people not living with relatives--unrelated individuals--are treated as one-person families in our analysis of the entire population.[4]

In our analysis of trends in income, the years that we examined are 1973, 1979, and 1987.[5] The years 1973 and 1979 were peaks in the business cycle--years in which incomes reached high points before declining in subsequent downturns--while 1987 is the most recent year during the current expansion for which income data are available. The magnitude of change in income reported here would differ if we had used other years, but the patterns would be essentially the same.[6]

---

[1] Congressional Budget Office publications on these subjects include: *The Changing Distribution of Federal Taxes: 1975-1990* (October 1987); *Trends in Family Income: 1970-1986* (February 1988); and "The Changing Distribution of Federal Taxes: A Closer Look at 1980" (July 1988).

[2] For the analysis of effective tax rates, incomes are adjusted for underreporting on the CPS and the income concept is expanded to include realized capital gains and each family's share of corporate income taxes and the portion of payroll taxes paid by employers.

[3] The official CPI has been based on the CPI-X1 methodology since 1983. The new approach improved the measurement of housing costs.

[4] A related issue is whether to focus on individuals or families. CBO's analysis examines the distribution of income among individuals, although the measure of income used for each person is the adjusted income of his or her family. For simplicity of expression, this testimony generally refers to the incomes of individuals as the income of the type of family in which they live.

[5] The analysis of changes in tax burdens starts in 1977 and includes 1980, 1985, and 1990. CBO has not analyzed effective tax rates for any year before 1977. In its 1987 study of effective tax rates, CBO looked at 1977, 1984, and 1988. At that time, 1984 was the most recent year for which complete tax data were available. 1977 was the year in the late 1970s most similar to 1984 in terms of economic performance, and it ended a period during which there were relatively few major changes in tax policy. The economy was much less healthy in 1980, but that year was later added to the analysis to isolate the effects of major tax legislation in 1981. The estimates have been updated to include 1985, for which data are now available, and 1990, a year when tax reform will be almost fully implemented and when the last scheduled social security payroll tax rate increase will occur.

## TRENDS IN FAMILY INCOME

In 1987, average adjusted family income was 17 percent higher than it had been in 1973, reaching about $41,000, for example, for a four-person family.

### Income Trends for Different Types of Families

While all types of families had higher incomes at the end of the period than their counterparts in 1973, gains varied widely among different family types, as Figure 1 shows.[7] The elderly experienced the greatest increases: childless elderly families in 1987 had adjusted family incomes 24 percent higher than similar families in 1973, while for elderly unrelated individuals the gain was 32 percent. Despite the rapid growth in their income, the latter group was hardly well off: in 1987, the incomes of unrelated individuals age 65 and over averaged about $12,000.

Married couples with children, unrelated individuals under age 65, and nonelderly families without children were closer to the average; the adjusted incomes for these groups were between 14 percent and 19 percent higher in 1987 than those received by their counterparts in 1973. Single mothers with children, the poorest group in 1973, had the smallest increase in income: compared with similar families in 1973, average income in 1987 was 11 percent higher, or just over $13,000 for a three-person family.

### Factors Contributing to Trends in Income

This growth in family income was the result of the complicated interaction of many factors. One was an increase in labor-force participation: the average number of full-time, full-year workers was higher in every type of nonelderly family in 1987 than in similar families in 1973. Another factor was the rise in earnings of certain types of workers. Among full-time, year-round workers, for example, the real median earned income of women rose 12 percent between 1973 and 1987, although this gain was offset to some extent by the 3 percent decline experienced by men.

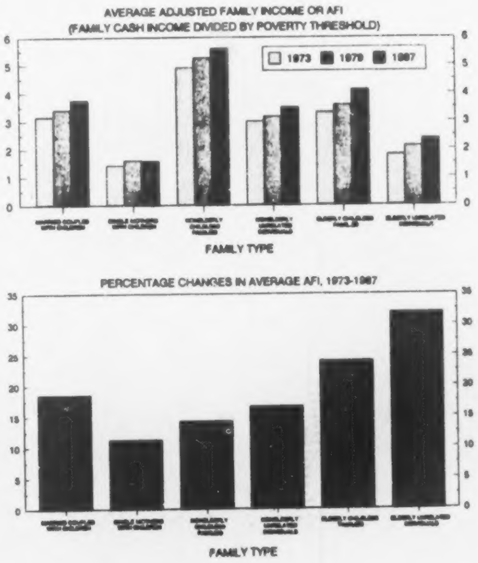
Another factor was that families with children shrank in size. The average number of children dropped from nearly 2.5 in 1973 to just over 2 in 1987. Even if such families had no higher real incomes in 1987 than comparable groups in 1973, they would have had a higher standard of living because they had fewer members to support. Finally, elderly families were better off in 1987 than their counterparts in 1973, in part because Social Security payments increased rapidly during the period. Two factors explain this rise: Social Security benefits were indexed to the CPI, which rose faster than the deflator (CPI-X1) used by CBO to adjust family incomes for inflation, and new retirees received larger Social Security payments than their predecessors.

---

[6] In particular, the choice of 1979 as the middle year does not affect the pattern of observed changes in adjusted family income. Using 1977 or 1982 instead would, however, shift the share of income change between the two periods.

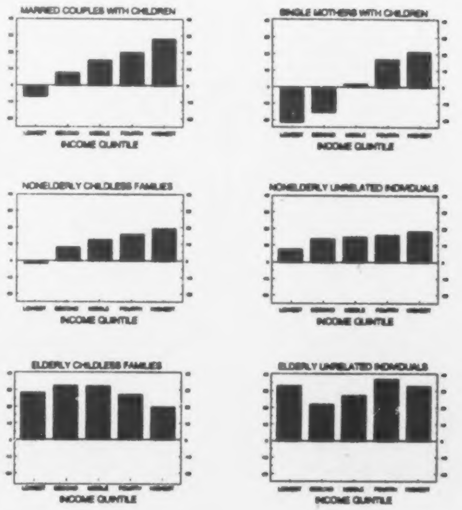
[7] CBO's comparisons of income show how the incomes of a given type of family in one year match up against the incomes of similar families in another year. This comparison is quite different from comparing the incomes of families in 1973 with the incomes of the same families in later years. Hence, readers should not interpret the findings as indicating how particular families fared during the period.

FIGURE 1. AVERAGE ADJUSTED FAMILY INCOME, 1973, 1979, AND 1987, AND THE CHANGES BETWEEN 1973 AND 1987, BY FAMILY TYPE



SOURCE: Congressional Budget Office tabulations of data from the March 1974, 1980, and 1988 Current Population Surveys.

FIGURE 2. CHANGES IN AVERAGE ADJUSTED FAMILY INCOME, BY INCOME QUINTILE AND FAMILY TYPE, 1973-1987 (IN PERCENT)



SOURCE: Congressional Budget Office tabulations of data from the March 1974, 1980, and 1988 Current Population Surveys.

## INCOME EQUALITY

When we consider all families and unrelated individuals together, we see that the distribution of income has become more unequal. The average adjusted family income of people in the bottom fifth--or quintile--of the population was 11 percent lower in 1987 than for their counterparts in 1973, while that for the top fifth was 24 percent higher. The 1987 average adjusted income of each of the middle three quintiles was also higher than for comparable groups in 1973, with greater increases for the higher-income quintiles.

Much of this increase in aggregate inequality was related to demographic shifts rather than to growing inequality of income within individual demographic groups. A particularly important factor was the growth in the fraction of the population consisting of nonelderly unrelated individuals. This group, which grew from 16 percent to 24 percent of all families over the 1973-1987 period, is overrepresented in the bottom two income quintiles.[8] Thus, even if there had been no change in the income distribution of each type of family, the growing importance of nonelderly unrelated individuals would have made the aggregate distribution more unequal. Examining what has happened to the distribution of income for different types of families is one way to remove the potentially misleading effects of this demographic change on the distribution of income.

### Changes in Equality for Different Types of Families

Inequality of income increased noticeably among three types of families, but changed relatively little for the rest, as shown in Figure 2. In fact, inequality grew much more among families with children than among childless families. Single mothers with children are the most extreme case: the average adjusted income in the top two quintiles was 17 percent and 21 percent higher, respectively, in 1987 than for comparable groups in 1973. On the other hand, people in the two lowest quintiles of single-mother families in 1987 had average family incomes 21 percent and 15 percent lower than their counterparts 14 years earlier. The income distribution for married couples with children also became less equal, although differences between 1973 and 1987 were not quite as large as for single mothers. Inequality increased noticeably less among nonelderly childless families and relatively little for nonelderly unrelated individuals.

Income inequality among the elderly changed little over the period. Among childless elderly families, average adjusted incomes for each quintile were between 19 percent and 31 percent greater than incomes of the same quintiles in the earlier year, with the highest-income quintiles having the smallest increase. Average incomes for elderly unrelated individuals in each quintile in 1987 were between 22 percent and 37 percent above the values for the corresponding groups in 1973, with the greatest growth for the bottom quintile and the top two quintiles.

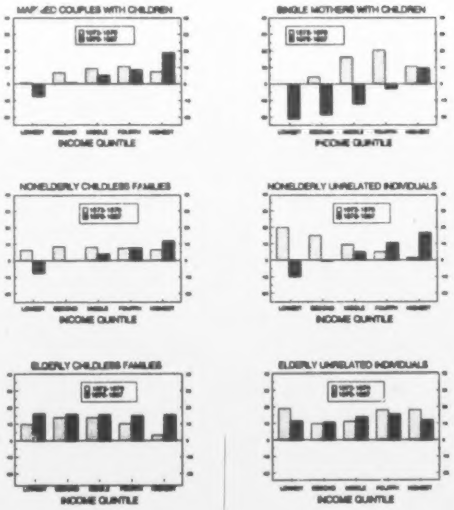
As Figure 3 shows, the increase in income inequality occurred largely between 1979 and 1987. During the 1973-1979 period,~~--there~~ was no consistent pattern among different types of families (see the light bars in Figure 3). Among married couples with children, for example, the lowest quintile lost ground relative to other families, but the other quintiles had about the same gains over their counterparts in 1973. On the other hand, inequality decreased among unrelated individuals under age 65. Only among single-mother families did inequality rise markedly during the period.

Between 1979 and 1987, incomes became more unequal for all types of nonelderly families. Adjusted incomes of families in the bottom quintiles were between 8 percent and 21 percent lower in 1987 than incomes of the

---

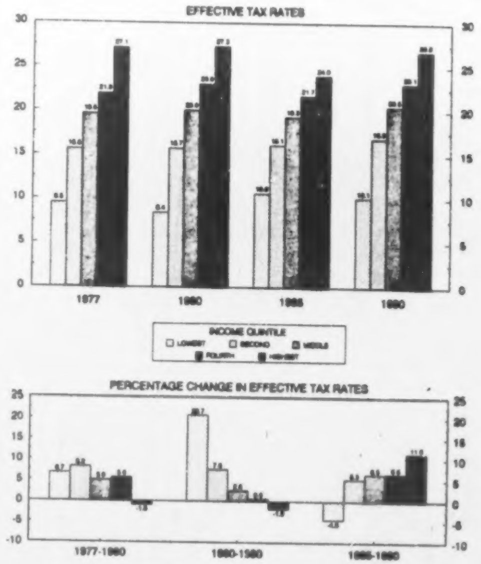
[8] This increase was offset by a decline in the proportion of families consisting of married couples with children--from 34 percent in 1973 to 25 percent in 1987.

FIGURE 3. CHANGES IN AVERAGE ADJUSTED FAMILY INCOME, BY INCOME QUINTILE AND FAMILY TYPE, 1973-1979 AND 1979-1987 (IN PERCENT)



SOURCE: Congressional Budget Office tabulations of data from the March 1974, 1980, and 1988 Current Population Surveys.

FIGURE 4. LEVELS OF AND CHANGES IN EFFECTIVE FEDERAL TAX RATES BY INCOME QUINTILE, 1977, 1980, 1985, AND 1990 (IN PERCENT)



SOURCE: Congressional Budget Office tax models.

corresponding quintiles in 1979. At the same time, the highest quintiles had 1987 incomes that were between 10 percent and 19 percent greater than comparable quintiles eight years earlier (see the dark bars in Figure 3). Except for single mothers, the average incomes of the middle three quintiles of each family type were higher--or only slightly lower--in 1987 than in 1979, with the percentage difference rising with income. For single mothers, these years were particularly bad; average income dropped for every quintile except the highest, and declines were greatest for the lowest quintiles.

In contrast, the adjusted incomes of elderly families continued the pattern visible during the 1973-1979 period. For every quintile of elderly families without children, average income in 1987 was about 15 percent higher than for the corresponding group in 1979, while for elderly unrelated individuals the comparable gains were between 11 percent and 16 percent.

## Factors Contributing to Changing Inequality

Many factors contributed to the increased inequality of income and the different patterns of change before and after 1979. For example, the average number of full-time, year-round workers in high-income families grew between 1973 and 1987, while low-income families had little or no change in their average number of workers. Income growth would, therefore, be expected to be higher for the top quintile.

Younger and older workers also experienced strikingly different changes in their incomes. The median dollar income of full-time, year-round workers remained the same or actually fell in real terms for groups age 35 and under, but rose for older ones. This disparity probably led to increased inequality, since the incomes of younger workers are lower on average than those of older workers. Furthermore, the impact of these larger differences in incomes among age groups has been made worse by the relative growth in the number of younger families.

Educational attainment has also affected the distribution of income, although to what extent is less clear. The disparity in incomes of workers with different amounts of education has grown since the early 1970s, but so too have levels of educational attainment. In 1987, male college graduates working full-time, year-round had average incomes that were 110 percent higher than workers with no high school degree, while in 1973 they were 87 percent higher. Over the same period, comparable values for women increased from 88 percent to 107 percent. On the other hand, between 1973 and 1987, participants in the labor force became more likely to have finished high school or college. The fraction with no high school degree fell from 32 percent in 1973 to 18 percent in 1987, while the fraction with college degrees rose from 14 percent to 22 percent. This increase in educational attainment probably offset in part the greater differentials in incomes associated with particular levels of education.

Finally, benefit levels in different transfer programs to help low-income families have changed unevenly since the mid-1970s. Between 1975 and 1987, for example, the maximum benefit in the median state for a three-person family receiving Aid to Families with Dependent Children (AFDC) fell roughly 25 percent in real terms. When combined with an increased dependence on means-tested transfers, this decline in benefit levels helps explain the large drop in the incomes of the poorest quintile of single-mother families. In contrast, federal benefit levels in the Supplemental Security Income (SSI) program increased with the CPI, which rose more quickly than the deflator used to calculate adjusted family incomes. Consequently, many of the poorest elderly and disabled people would have had higher adjusted incomes in 1987 than their counterparts in 1973.

## CHANGING PROGRESSIVITY OF THE FEDERAL TAX SYSTEM

Because of changes in the federal tax system, the after-tax distribution of income has become slightly more unequal since the mid-1970s. The top panel of Figure 4 shows effective federal tax rates--the percent of income paid in taxes--for people ranked in quintiles by their adjusted pretax family income.[9] These estimated federal tax rates combine the effects of the individual and corporate income taxes, the employee and employer portion of social insurance payroll taxes, and excise taxes other than the windfall profit tax. They also reflect specific assumptions, described in the box on page 16, about which families bear the economic burden of each tax.

In 1990, the effective tax rate for the one-fifth of people in families with the highest incomes will be 26.8 percent, slightly less than it was in 1977 or 1980. The effective tax rates for people in the remaining four quintiles will be higher than they were in either 1977 or 1980.

As a result of these changes in effective tax rates, federal taxes in 1990 will be less progressive than they were in either 1977 or 1980, but more progressive than in 1985.[10] This shift is illustrated in the bottom panel of Figure 4, which shows percentage changes in effective tax rates by quintiles. Among the people in the bottom four-fifths of the income distribution who will face higher tax rates in 1990, the percentage increase is generally greatest for people with the lowest incomes. Moreover, within the top quintile, which will experience a decrease in effective tax rates, the drop in taxes will be concentrated among people in the top 5 percent. This decline in progressivity relative to 1977 and 1980 occurs even though, as Figure 4 shows, the tax system will be more progressive in 1990 than it was in 1985.

### Causes of the Changes in Progressivity

What has caused the tax system to become less progressive than it was a decade ago? The top panel of Figure 5 shows that it is not because the individual income tax has become significantly less progressive. Although substantial changes in the individual income tax took place from 1977 to the present, the net result of these changes is that effective tax rates are projected to be quite similar in 1990 to what they were in 1977. The exception is for people in the lowest quintile, whose effective rate will fall by about one percentage point.

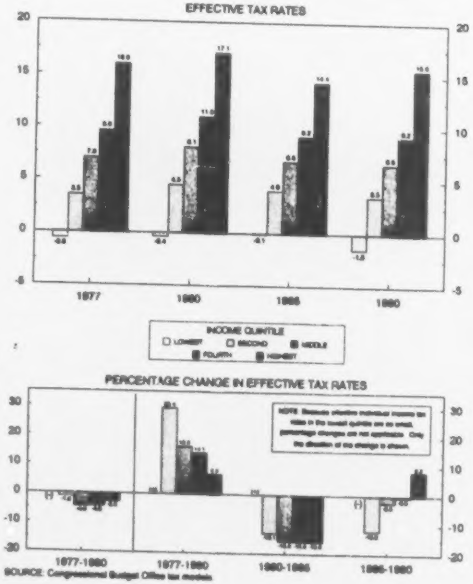
The individual income tax did become less progressive between 1977 and 1985, as the bottom panel of Figure 5 indicates. Between 1977 and 1980, tax rates rose for all groups, since rising incomes pushed taxpayers into higher tax brackets. Low-income people experienced the largest increases in tax rates because they were most affected by the erosion in the real value of the personal exemption and standard deduction. Although the personal exemption, the standard deduction, and the earned income credit were raised in 1978, the increases were too small to offset the effects of rapidly rising nominal incomes and the expiration of the general tax credit. In addition, while the 1978 reduction in the tax on capital gains helped upper-income people, it did little for those at the low end of the income distribution.

---

[9] For purposes of analyzing the distribution of federal taxes, adjusted pretax income includes all cash income plus realized capital gains and is measured before all federal taxes, including those collected from business but assumed to be borne by families. Thus, adjusted pretax income also includes the corporate income tax and the employer share of payroll taxes. Tax rates for the lowest quintile were calculated excluding families with negative or zero incomes. For consistency with the analysis of trends in family incomes, two changes were made from previously published CBO estimates of effective tax rates. For purposes of grouping families into quintiles, family income is divided by the poverty threshold for the appropriate family size, and quintiles contain equal numbers of people rather than equal numbers of families.

[10] The distribution of taxes is classified as progressive if the ratio of taxes to income rises as incomes rise, as regressive if the ratio falls as income rise, or as proportional if the ratio is the same at all income levels.

FIGURE 5. LEVELS OF AND CHANGES IN EFFECTIVE FEDERAL INDIVIDUAL INCOME TAX RATES BY INCOME QUINTILE, 1977, 1980, 1985, AND 1990 (IN PERCENT)

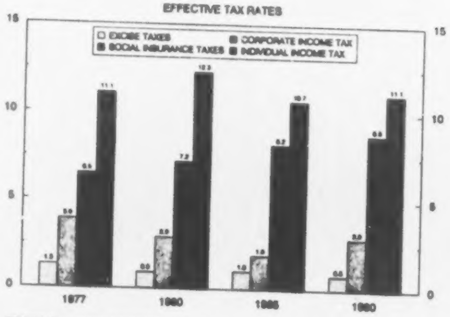


EFFECTIVE TAX RATES

PERCENTAGE CHANGE IN EFFECTIVE TAX RATES

SOURCE: Congressional Budget Office tax models.

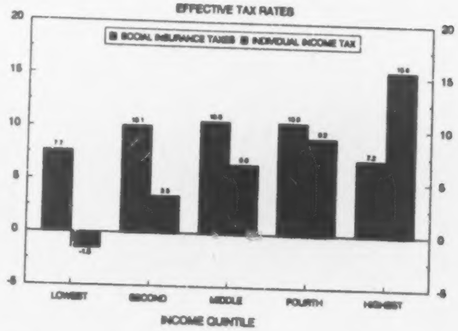
FIGURE 6. EFFECTIVE TAX RATES BY TAX SOURCE, 1977, 1980, 1985, AND 1990 (IN PERCENT)



EFFECTIVE TAX RATES

SOURCE: Congressional Budget Office tax models.

FIGURE 7. EFFECTIVE INDIVIDUAL INCOME AND SOCIAL INSURANCE TAX RATES BY INCOME QUINTILE, 1990 (IN PERCENT)



EFFECTIVE TAX RATES

SOURCE: Congressional Budget Office tax models.

### The Incidence of Federal Taxes

The tax estimates reported in this testimony reflect specific assumptions about who bears the economic burden of particular taxes. The burden of the individual income tax and the portion of the payroll tax collected from employees is attributed to the families who directly pay these taxes. The portion of the payroll taxes collected from employers is assumed to be shifted back onto employees in the form of lower wages. In addition, excise taxes are assumed to be passed forward to individual consumers in higher prices on goods subject to tax.

Finally, although the corporate income tax is collected from corporations, individuals are assumed ultimately to bear its economic burden. Economists disagree about who is affected by the corporate income tax. One theory is that all income from capital is lowered by the amount of the corporate tax. A competing theory is that, because capital can be invested in foreign economies and thus escape the corporate tax in the United States, workers bear the tax's economic burden in the form of lower wages.

In previous published studies of the distribution of taxes, CBO has shown both allocations of the corporate income tax as alternatives. The method of allocation, however, does not affect our main conclusions about how the distribution of the tax burden among income classes has changed over time. Thus, to simplify the presentation in this testimony, half of the corporate income tax is allocated to capital income and half to labor income.

The Economic Recovery Tax Act of 1981 (ERTA) cut the effective tax rates of people in all but the lowest quintile between 1980 and 1985. People in the lowest-income families did not benefit, because personal exemptions, the standard deduction, and the earned income tax credit were not raised again until 1985.

CBO's projections indicate that recent changes in tax law--especially the Tax Reform Act of 1986 (TRA)--will make the individual income tax more progressive in 1990 than it was in 1985, and thus restore 1990 effective tax rates to approximately their 1977 levels. This projected increase in the progressivity of the individual income tax reflects several features of tax reform. Substantial increases in personal exemptions, the standard deduction, and the earned income credit have eliminated income tax liabilities for millions of low-income families. In addition, even though the maximum statutory tax rate was significantly lowered, restrictions on tax preferences and repeal of the capital gains exclusion broadened the base of taxable income enough to increase the average effective rate paid by high-income taxpayers.

The major factor in reducing the progressivity of federal taxes is the increased reliance on social insurance payroll taxes. Because social insurance taxes are levied only on earnings and only on earnings below a maximum amount, they are much less progressive than individual income taxes among the four lowest quintiles, and are regressive in the upper part of the income distribution. In 1990, payroll taxes will account for a larger fraction of total revenue than they did in either 1977 or 1980. Figure 6 shows total effective tax rates for each of the four taxes. While individual income taxes are projected to remain roughly constant as a share of income, the share of income paid in social insurance taxes is projected to rise from 6.5 percent in

1977 to 8.8 percent in 1990. This 35 percent increase results from the higher Social Security contribution rates enacted in the Social Security Amendments of 1977.

Figure 7 shows how much less progressive social insurance taxes will be than individual income taxes in 1990. Effective income tax rates will rise sharply with income, while social insurance tax rates will rise more slowly and then drop for the 20 percent of people with the highest incomes. This pattern was true for 1977, 1980, and 1985 as well. Figure 7 also shows that, by 1990, people in the bottom 80 percent of the income distribution will pay more in social insurance taxes than in income taxes. By comparison, in 1980, only people in the bottom half of the income distribution paid more in social insurance taxes than in income taxes.

## CONCLUSION

During the past decade and one-half, incomes have risen for all types of families. Contributing to this increase were general economic growth and consequently higher earnings, increased participation in the labor force, and smaller families. At the same time, incomes have become more unequal among nonelderly families, particularly since 1979. Likely factors contributing to this growth in inequality include changes in the number of working members in various types of families, the earnings of workers of differing ages, and educational attainment. Moreover, because the share of revenue raised from progressive taxes--mainly the individual income tax--has declined, this pattern of increasing inequality was exacerbated by the federal tax system, which has become somewhat more regressive than it was in the mid-1970s.

Chairman ROSTENKOWSKI. Bob, would you focus in a little bit on the senior citizens, their tax benefits, as opposed to those of the lower income groups in our society?

I would like to hear a little bit more about—even with the catastrophic health bill that we passed and the premium that is going to be paid—I would like to hear a little bit more about your comparisons with respect to the poor in our society.

Mr. REISCHAUER. On balance, looking at, let's say 1990, when the tax changes that were made in 1986 are phased in, the elderly will still have effective tax rates that are substantially below the tax rates faced by the nonelderly population.

For the bottom two quintiles, effective tax rates will be roughly a third of what nonelderly families with children face in the way of taxes.

If you go up to the highest quintile, the richest of the elderly versus the richest of the nonelderly, you will find that the elderly's tax burden, including the catastrophic health premium, is about 7 percent below the burden faced by the nonelderly families.

In total, the catastrophic health care burden through the income tax will add about seven-tenths of a percentage point to the tax burden of the elderly taken as a group, but of course it will be concentrated only on those that fall in the top two quintiles, the richest of the elderly, and for them it is something on the order of a 1 percentage point increase in their effective tax rates.

But, as I said, even after this burden is placed on them, they still face tax burdens that are below those of other Americans similarly situated in the income distribution.

Chairman ROSTENKOWSKI. Mr. Moody.

Mr. MOODY. Thank you.

I found this a very interesting and helpful paper. It is pretty self-explanatory. I would like to shift my questioning from the paper to the question of the debate about the implications of having the Social Security System accumulate those huge surpluses.

Discuss, if you would, a little bit about whether or not these surpluses are on or off budget, whether or not they are counted, whether or not the deficit should be counted separately or whether they should be placed in a trust fund, if that matters at all.

In terms of productivity and long-term ability to meet our obligations to the retirees, do you have any comment on that question?

Mr. REISCHAUER. I think the real issue here is whether the Social Security surpluses are adding to net national saving or are masking the true size of the deficit that exists in the non-Social Security accounts. Is Congress willing to spend more and tax less, because it is looking at a deficit that is $150 billion or $159 billion this year than would be the case if it had to add another $55 to $60 billion to that deficit?

That is a behavioral question. We don't know the answer to that, and so we are left with a problem.

I, for one, think that given we have made a commitment to future generations, that it would be prudent for this generation of workers and consumers to treat the Social Security surplus as a fund that should be added to our net national savings, should increase the capital stock, and that should increase the wealth of the Nation so that the pie, in a sense, will be bigger 30 years from now when we begin drawing down those funds, and paying the retirement benefits of the baby boom generation.

Mr. MOODY. The key question is not whether to be on or off budget; that is not the issue. The issue is whether or not they substitute for savings that we would otherwise make.

Mr. REISCHAUER. There are a number of different dimensions to this. If we are going to use the resources in the Social Security Trust Fund to support day-to-day Government activities, there is not only an intergenerational issue, but also an issue of relative tax burdens within a generation.

We like to think that we are supporting the day-to-day operations of our Government through excise taxes, through income taxes, and through corporate income taxes, not through payroll taxes. To the extent that we do use these surpluses to support higher levels of public spending or lower other taxes than we would otherwise, we are shifting the distribution of the burden for paying for current services in a regressive direction and a direction that I don't think we intended in 1983 when we made the changes in the Social Security System.

Mr. MOODY. Your charts Nos. 6 and 7 are particularly interesting. They show that the Social Security taxes—social insurance, that includes Medicare, not just Social Security, right?

Mr. REISCHAUER. Yes.

Mr. MOODY. They are shown to be faintly progressive here, is that right?

Mr. REISCHAUER. Yes. I mean, the social insurance tax rate rises because the fraction of all income attributable to labor income or wage income rises as you go up the quintiles.

Mr. MOODY. As opposed to transfer income?

Mr. REISCHAUER. Yes, dividends work the other way. When you get to the top quintile, you are dealing with people whose earnings are beyond the Social Security maximum and so it falls.

Mr. MOODY. So we are basically financing an increasing share of Government with a payroll tax, that is what it amounts to if we don't set it aside and use other tax systems to balance the budget net of Social Security surpluses?

Mr. REISCHAUER. If.

Mr. MOODY. Yes, which we don't seem to be prepared to do. We are counting it now in the budget deficit on the revenue side, and I don't know anyone who thinks we are going to suddenly, in 1992, change that system.

Can you imagine us trying to pick up $90 million?

Mr. REISCHAUER. I think the unresolved issue is whether if changes had not been made in the Social Security System in 1983, and actually 1977 as well, that guaranteed this surplus and instead it had been run basically on a pay-as-you-go basis, whether we would not have had a deficit this year of $210 billion, without changing our behavior one iota.

Mr. MOODY. Interesting question.

My time has expired, Mr. Chairman. Thank you.

Chairman ROSTENKOWSKI. Mr. McGrath will inquire.

Mr. MCGRATH. Thank you, Mr. Chairman.

Thank you, Bob, for great testimony. I would just like to react to something I heard and something that I have gleaned from the hearings today.

I had the chairman of Discover Card in the other day from Sears. We thought during tax reform that when we scaled down the value of the consumer interest deduction, that we would be affecting some behavior in terms of the public's willingness to buy. I have heard today that the incentives we may have put into the Tax Code in order to have people save haven't really worked.

The fact that we have reduced or eliminated the deductibility of consumer interest has not changed the buying patterns of the American people. They are continuing to use these credit cards to a larger extent than they did before. We had IRA's, Keoghs, 401(k)'s, and still the savings rate seems to be going down.

Is there anything that we can do to change people's behavior? Seemingly we have tried on two occasions, one on the spending side and the other on the savings side, and it hasn't worked. What is the answer here?

Mr. Reischauer. The answer is, if you really want to raise national saving, reduce the deficit. But I am sure that isn't the answer you wanted me to give.

Mr. McGrath. We are talking in terms of creating incentives to save. What I am beginning to believe is that whatever we create, it is not going to help.

Mr. Reischauer. As an economist, I have to believe that the kinds of changes that you have made probably have had some impact, but I think the impacts are really very small relative to other forces in the economy.

The advertising that Sears does to get people to use the Discover Card is much more powerful than your gradual reduction in the interest, in the tax writeoff for interest on consumer debt.

Remember, these things are still being phased in, and so the full impact of them hasn't hit the American consumer.

Mr. McGrath. Over the last 3 years, we have reduced it probably 20 percent in value. Yet there seems to be an increase, a large increase in the amount of consumer debt being incurred.

Chairman Rostenkowski. Would the gentleman yield?

Mr. McGrath. Yes.

Chairman Rostenkowski. Haven't we become accustomed to, in a real estate deal, an automobile deal, you get a point for the interest that you accumulate? When I was a kid, if my father walked in to buy an automobile and the automobile cost $800 in the retail store and he came in with cash, he got the car for $750.

Today, you go to buy an automobile and they want the interest. They pick up points on it. They are making money on it. It is a society attitude as to what is Sears saying about having a Discover Card or what is American Express suggesting.

Mr. Reischauer. They are both in the business of selling cars or clothes or whatever and in the business of providing credit, so they would rather that you buy both of their products rather than just one.

Chairman Rostenkowski. Yes. So it is really what the American people have started to accept as part of doing business.

Mr. **Reischauer**. On the other hand, the existence of credit and the long-term loan for a car versus the situation when your father went in to buy a car is that we have democratized a lot of goods that used to be luxury goods. We have made them affordable to people who wouldn't save unless they are forced to save in the form of buying things on time. That is a plus. I think we have a more equitable distribution of what used to be luxury goods in our society as a result of this.

Chairman **Rostenkowski**. You know, everything that we have been hearing indicates that in this country we reward borrowing and we penalize savings. We go after them. In the bank, we tax the interest. Whereas if, at least up until the 1986 act, if you went out and borrowed money, you got the tax writeoff, you got the deduction. It is a whole attitude that we have educated—my daughters are unbelievable. My wife will even agree with this.

Mr. **Reischauer**. I will match my daughter against yours any day.

Chairman **Rostenkowski**. They are all under 30, and so what? It is just part of their life style. It is just unreal how—it is a whole different view of how the world turns.

I didn't mean to impose on your time.

Mr. **McGrath**. That is quite all right, Mr. Chairman.

I guess my point is that we are here to discuss long-term strategies to increase savings rate or to reduce spending, and it seems that no matter what we do in the Tax Code, we are not having an effect. I am wondering whether or not the exercise is all worth it under those circumstances.

Mr. **Reischauer**. I think the conclusion from the experiments we ran in the early 1980's, which asked how to provide various incentives for people to save, has to be that these incentives had very small impacts relative to other forces in the economy that determine saving behavior.

Chairman **Rostenkowski**. Mr. Downey.

Mr. **Downey**. Mr. Chairman, I haven't had a chance to congratulate Mr. Reischauer on his achieving the directorship of the CBO. I want to do that publicly. I am a great fan of his and I think the work that he has done is just an example of what he has testified to before us today. It has been terrific, and I hope you continue the good work.

Let me ask the question about why the poor have gotten poorer in a different way. Why have the rich gotten so much richer?

Mr. **Reischauer**. One answer I gave in my testimony was that the top quintiles now have more workers per family unit. Since more workers produce more income, these families have pulled away from the people at the bottom where the number of workers per family unit stayed about constant. That is one answer.

We can't really take the incomes of the very top group and examine them with any kind of rigor, however, because the data we collect in this country are top-coded. Incomes over $100,000 are classified as just $100,000 because of confidentiality aspects, so you can't really dissect that top group and put it under a microscope.

But if you look at the next group down, you find that income from dividends and interest and rental property went up very rapidly over this period. In other words, these are the folks who have wealth, and the return from wealth was very good.

If you have money in a savings bank, the real rates of return are at historic levels right now. That has been another factor which I think must have contributed to this acceleration of income growth at the top.

Mr. DOWNEY. Why should we worry about the growing gap between the rich and the poor? We live in a free market economy, so people are not going to do so well, some people are going to be better. Why should that be of concern to the Government?

Mr. REISCHAUER. There are a couple of answers to that question. The first, I would say, is that we are a democracy, and the foundation of a democracy is that the people believe that the system is fair. Their view of a fair system, I think, depends on people's chances of living a good life. If that prospect is held out only to a few or to one group in society and denied to others, there is likely to be an erosion of faith in the system.

Second, the United States has, I think, a lot of moral authority in the world, and is the leading example of capitalism. If we want to remain an example which Third World countries and others turn to as a model, we have to maintain a society that is perceived in the rest of the world as basically fair and just. When you have tremendous gaps in inequality, that doesn't fall into people's understanding of what justice is, and you begin to be looked upon more as a banana republic than as a role model for the rest of the world.

Finally, I would think that we should worry about this because when income inequality grows because of private market forces, the pressure builds in our society to have government redress those inequalities through tax policy and through welfare policy. As you know only too well, redistributive policies both on the tax and the spending side are divisive issues in this country that tend to rend the body politic.

It would be nice if the market system produced a more equal outcome and that equal outcome then didn't require massive kinds of intervention on the part of the Government.

Mr. DOWNEY. Would you agree that there is a side from this growing income disparity being inimical to the health of a democracy?

Would you make the argument that having 20 percent of the Nation's population not being part of the national economic mainstream causes a level of social disinclination that sees its outlet in rising crime and behavior that the other 80 percent find unacceptable?

Mr. REISCHAUER. Unquestionably, I think that is right.

Mr. DOWNEY. Can you address for a moment the comparative income inequality we have in our country with those of the other developed nations of the world? Do you have that readily available? If not, then——

Mr. REISCHAUER. Yes. I can say some things about that. A project is going on in Luxembourg—an income dynamics project looking at comparative rates of poverty in the United States and six or seven other industrialized countries ranging from Australia and Canada to Germany, Switzerland, Great Britain, Norway, and Sweden.

The bottom line of that study, which looks at where things were in the early 1980's in these countries, is that the United States has the highest poverty rate for children of any of the countries examined, and falls into about the middle of the pack when one considers the poverty rate among the elderly.

Interestingly enough, Great Britain has a much higher poverty rate among the elderly than the United States does. The United States, however, has the dubious distinction of having the highest child poverty rate among all the countries examined, and I think this says something about where the future of our country might well lie.

Mr. DOWNEY. I am trying to remember when it was—it probably is as many as 5 years ago that I remember reading a comparative study that had only the French as a more disparate group of income distribution than the United States, that England was a little better than we, but that the French had greater concentrations of wealth at the top.

I guess that is a matter I could find if I looked hard enough in the Green Book, too.

Mr. REISCHAUER. The French aren't included in the study I mentioned because they don't have the kind of statistics that one needs, and so this must be a different piece of information.

Mr. DOWNEY. Can I ask, I have what I consider to be one way to address this problem, and that is by the dramatic expansion of the earned income tax credit and refundability of the dependent care credit to be financed by changing the top rate from 28 to 33 percent.

Chairman ROSTENKOWSKI. Just so you understand, Doctor, a lot of people have a claim on the money he is talking about.

Mr. DOWNEY. Yes. Many people have claim on the money, but few asked earlier than I.

Mr. MCGRATH. I asked for capital gains.

Mr. DOWNEY. Yes.

Can you address the effectiveness of the earned income tax credit as a way of dealing with or addressing some of this mal-income distribution?

Mr. REISCHAUER. You put me in a difficult position. I would have gladly answered this question with gusto a month-and-a-half ago.

Mr. DOWNEY. You could do it without gusto. I could ask the Chairman to leave the room.

Mr. REISCHAUER. The earned income tax credit is clearly an effective means of raising incomes for working families with children. Many of the families within the bottom quintile have very limited attachment to the labor force, however.

One could argue that an increase in the earned income tax credit would increase the incentive for those individuals to join the labor force, and I would hope that this would be the case and that the increases made in the 1986 act will have this effect. I would expect to see these effects occur very gradually—these aren't the kinds of things that bring rapid responses.

Mr. DOWNEY. I won't put you under the gun any more.

Thank you, Mr. Chairman.

Thank you, Dr. Reischauer.

Chairman ROSTENKOWSKI. Doctor, to get money to children, child care credit, earned income credit, what would you suggest?

Mr. REISCHAUER. In my new life, I am not supposed to suggest anything.

Chairman ROSTENKOWSKI. What would you observe, then? If you were off the record.

Mr. REISCHAUER. I will tell you in Savannah.

Chairman ROSTENKOWSKI. I will wait for Savannah.

Mr. DOWNEY. I intend to go to Savannah.

Chairman ROSTENKOWSKI. Any further questions?

Thank you very much, Bob. We enjoyed having you.

Our next panel is Mr. Christian, Mr. Swanstrom, Ms. Thorning, and Mr. McIntyre.

Welcome, ladies and gentlemen, to the committee. It is nice to have you join us. You all know the rules. We would like for you to limit your remarks if they are longer than 5 or 6 or 7 minutes in your written testimony, to a summary, and at the conclusion of that we will get into a dialog with you.

Mr. Christian, if you would like to begin with your testimony, the committee is ready to receive it.

## STATEMENT OF ERNEST S. CHRISTIAN, JR., ESQ., PATTON, BOGGS & BLOW, WASHINGTON, DC

Mr. CHRISTIAN. Thank you very much, Mr. Chairman. I appreciate being here.

I will try to address the potential effects on savings in the United States if a value added tax were to be substituted for all or part of the existing income or payroll tax system.

Many wrongly equate a VAT with a national sales tax. In reality, a VAT is a tax measured by the output value of both capital and labor. The tax is imposed on and paid by corporations and other businesses in proportion to the value that is added by each.

Consider, if you will, the following illustrative proposition. Step 1: Enact a 10-percent VAT which would raise about $300 billion per year. About $50 billion of that would come from the import portion of the VAT, primarily from foreign manufacturers that sell into our markets, but are not now asked to pay their share of the costs of the U.S. Government. The remaining $250 billion would come from value added in the United States.

Step 2: Earmark the $50 billion import portion of the VAT for immediate deficit reduction.

Step 3: Use the remaining $250 billion to pay for an offsetting $250 billion reduction in existing U.S. income and payroll taxes.

There would be no net U.S. tax increase. There would, however, be an immediate $50 billion reduction in the deficit.

At present, there are two major problems with savings. First, the large amount of existing savings that is absorbed by government dissaving when the Treasury borrows to make up for the deficit between tax revenues and expenditures. Second, the low rate of saving in the United States to start with.

A $50 billion reduction in the deficit unaccompanied by a corresponding net increase in taxes on ourselves would release a large amount of savings for productive private investment. Substitution of a VAT for income taxes would reduce the bias against saving and, therefore, should enhance the rate of saving in the United States in the future.

In comparison to the taxes it would replace, a VAT may be evaluated against the following basic criteria:

Regressivity versus progressivity: A replacement VAT would not produce a regressive result. Mere substitution of a VAT, dollar for dollar, for existing taxes would not necessarily cause any significant increase in the cost of consumption at all. At most, the aggregate dollar increase in the cost of consumer products would be only a fraction of the offsetting reduction in income and payroll taxes.

Because the personal income and payroll tax cuts would be concentrated on low- and middle-income workers, their offsetting tax cuts should, in fact, exceed any additional cost to them of consumption. The tax system as a whole might be more progressive than at present, especially keeping in mind that the highly regressive payroll tax would be greatly reduced.

Simplicity versus complexity: If simplicity is a goal, as I believe it should be, the VAT is clearly a winner.

Neutrality versus distortion: There is near uniform agreement that a VAT is a far more neutral and efficient tax than the present combination of income and payroll taxes that it would replace.

Broad-base versus narrow-base: Because a VAT taxes output, the output of capital and the output of labor, the base is nearly equal to GNP, and is, therefore, very broad and uniform.

Low rates versus high rates: Because the base is broad, the rates of a VAT are by definition very low.

Therefore, it may very well be that the value added tax could be the next logical step in the fundamental reform of taxes begun by this committee in 1986. That was a process of lowering tax rates and otherwise removing impediments to economic growth that result solely from the way we presently raise revenue.

Taxing savings once versus taxing savings twice: Although a value added tax includes in the tax base all forms of output including the value produced by the use of savings, which is capital, the VAT excludes from the base savings as such. In contrast, an income tax includes in the tax base both savings as such, as well as the income or value produced by savings.

Single tax versus double tax: The committee is very familiar with the present double tax on net income that is initially realized in corporate form and with what, I believe, is the major mischief caused by that double tax.

If a VAT were substituted for both corporate and personal income taxes, the output value of both wages and capital would be taxed once and that single tax would be paid at the corporate or business level.

Consistency with U.S. tax history: A VAT would not be inconsistent with tax history in this country. Prior to 1965, we imposed a broad array of excise taxes. A VAT is really just a refined version of an excise tax designed to be more neutral and efficient at home and to help level the playing field abroad.

Political acceptability to the voters: It is obvious that people would welcome another income tax rate cut, and we might imagine the probable dramatic response to cutting in half the payroll tax which is concentrated on low- and middle-income wage earners and, for many, is probably their heaviest tax burden.

Despite the very real differences between a value added tax and a national sales tax, and those differences are large, many people in general will necessarily equate a VAT with a national sales tax. That, however, is not necessarily a political negative.

One recent poll indicates that most people would prefer a national sales tax to an income tax increase for deficit reduction purposes. Another recent poll shows that today people are still dismayed by the complexity of the personal income tax despite the efforts of this committee to simplify it.

It may very well be that the idea of substituting a VAT for all or part of the income tax is at least worth consideration.

Thank you very much, Mr. Chairman. That concludes my oral statement.

[The statement of Mr. Christian follows:]

**Statement**
**of**
**Ernest S. Christian, Jr.**
**Before**
**Committee on Ways and Means**
**U.S. House of Representatives**

April 19, 1989

**Re: Substituting a Value-Added Tax For Existing Income and Payroll Taxes -- Some Effects on Savings, Distribution of the Tax Burden, and Economic Growth**

My name is Ernest S. Christian. I am a partner in the law firm of Patton, Boggs & Blow, Washington, D.C. Today I am testifying on my own behalf as a former Treasury tax official and co-author of a recent book on value added taxes, **The Value Added Tax: Orthodoxy and New Thinking**.

Properly understood and implemented, a tax on value added could eliminate the bias against savings, distribute the tax burden more fairly and equitably, and greatly simplify the present tax system. Coincidentally, substitution of a VAT for all or part of present income and payroll taxes could also take us a long way toward elimination of the annual budget deficits which absorb large amounts of existing savings. All this might be accomplished without any significant tax increase on Americans.

My recent work on the book convinced me that the value-added tax may be the next logical step in fundamental tax reform begun in 1986 -- a process of lowering tax rates and otherwise removing impediments to economic growth that result solely from the way in which we presently raise revenue.

The VAT is often misunderstood. Many wrongly equate a VAT with a national sales tax. In reality, a VAT is a tax measured by the output value of both capital and labor. The tax is imposed on and paid by corporations and other businesses in proportion to the value added by each. As in the case of other taxes which directly or indirectly increase business costs, businesses must try to pass on to customers all or some part of that tax. In contrast, consumers pay a sales tax and must try to pass back to businesses all or some part of the tax through price resistance.

Merely because a VAT does not tax savings as such does not mean that a VAT is a tax on consumption in the sense of a national sales tax. Merely because a VAT may be used to identify the possible tax component of prices -- which is disguised under the present system -- does not necessarily mean that a VAT is regressive in the sense of increasing the burden on low income families who spend the largest percentage of their incomes on the purchase of necessities. Merely because the VAT would tax the output value of both labor and capital only once, instead of twice as in the case of capital under the present system, does not necessarily mean that there would be any radical change in the distribution among income classes of the total tax burden.

The positive potential of a VAT can best be seen by setting aside the notion of adding on a VAT to the present system; and by considering, instead, the idea of substituting a VAT for present income and payroll taxes.

Consider, if you will, the following illustrative proposition:

Step One: Enact a 10 percent VAT which would raise about $300 billion per year.

a. About $50 billion -- in the final analysis the only net revenue increase -- would come from the import portion of the VAT; primarily from foreign manufacturers that sell into our markets but are not now asked to pay their share of costs of the U.S. Government. It is not unreasonable to charge them a "user" fee.

b. The remaining $250 billion would come from value added in the U.S. as reflected in goods and services that are produced and sold here.

Step Two: Earmark the $50 billion import portion of the VAT for immediate deficit reduction.

Step Three: Use the remaining $250 billion to pay for an offsetting $250 billion reduction in existing U.S. income and payroll taxes. There would be no net U.S. tax increase.

The effect of all this on savings and other related subjects of these hearings can best be seen by a comparison with the present situation. At present there are two major problems about savings: first, the large amount of existing savings that is absorbed by government dissaving when the Treasury borrows to make up for the deficit between tax revenues and expenditures; and second, the low rate of saving in the U.S. to start with.

A $50 billion reduction in the deficit -- primarily paid for by foreign manufacturers and unaccompanied by a corresponding net increase in taxes on ourselves -- would release a large amount of savings for productive private investment. Substitution of a VAT for $250 billion of existing income and payroll taxes would reduce the bias against saving and, therefore, should enhance the rate of saving in the U.S. in the future.

This and other results of a VAT substitution can be seen by a more detailed comparison of a VAT and the income and payroll taxes it could replace. Let us assume as our model a VAT in the range of 10 to 15 percent (depending on the degree of substitution desired) which would in all cases provide $50 billion for deficit reduction and (i) replace a substantial portion of the payroll tax; (ii) replace the corporate income tax; and (iii) pay for a significant cut in income tax rates for lower/middle income individuals.[1]

Such a model may be evaluated against the following basic criteria.

---

[1] Payroll tax receipts are about $240 billion, corporate income tax receipts are about $110 billion and individual income tax receipts are about $400 billion. After setting aside $50 billion for immediate deficit reduction, a 10 percent VAT would raise about $250 billion in revenues for offsetting domestic tax cuts that exactly equal the domestic portion of the VAT. There would be no net increase and no net decrease in domestic taxes. Each additional percentage point would raise an additional $30 billion of which one-sixth or $5 billion would be from foreign manufacturers. If the VAT rate were 15 percent and the contribution to deficit reduction were held constant at $50 billion, available revenues ($400 billion) would exceed the domestic portion of the VAT ($375 billion) and would pay for a net decrease in domestic taxes.

Regressivity vs. Progressivity. A replacement VAT would not produce a regressive result in the sense of imposing a heavier burden than now on lower income people who spend the largest percentages of their income on the purchase of necessities. In the first place, the mere substitution of a VAT for existing taxes which directly or indirectly increase business costs would not necessarily cause any significant increase in the cost of consumption. There should be no more than a modest one-time increase in prices that is later diminished as the economy adjusts to the absence of the other taxes. The import VAT is, of course, an additional tax but the desire of foreign manufacturers to maintain market share (in the face of competition from goods produced in our domestic economy where there will have been no net tax increase) should cause them to absorb most of the tax on imports. At most, the aggregate dollar increase in the cost of domestic and imported consumer products would be only a fraction of the offsetting reduction in income and payroll taxes. Moreover, because the personal income and payroll tax cuts would be concentrated on low and middle income workers, their offsetting tax cuts should exceed any additional cost to them.[2] The tax system as a whole might be more progressive than at present; especially keeping in mind that the highly regressive payroll tax would be greatly reduced.

Simplicity vs. Complexity. If simplicity is a goal -- as it should be given the overwhelming complexity of the present system -- the VAT is a winner. On a complexity scale of one to ten, the VAT is a one and the present U.S. income tax is a twenty. From the standpoint of people in general, there is no complexity at all. Any business that can even get to first base in complying with the present income and payroll tax system can easily handle the VAT with a lot of time and resources left over to devote to something productive. The often voiced idea that a VAT is some horribly complex system is either a red herring or an honest mistake born of having spent too much time studying various European sytems which are far more complex, primarily in appearance, than they need be. However derived, the impression that a VAT is complex is false.

Neutrality vs. Distortion. Despite the efforts of this Committee in 1986 and otherwise, the combination of the personal and corporate income taxes, plus payroll taxes, continues to exert a substantial distorting influence on economic choices and behavior in general. Less-than-efficient allocations of resources and less-than-maximum GNP growth are the consequences. While there are disagreements about other aspects of such a tax, there is near uniform agreement that a VAT is a far more neutral and efficient tax than the present combination of income and payroll taxes.

Broad Base vs. Narrower Base. Because a VAT taxes output (the output of capital and the output of labor) and the base nearly equals total GNP, the base of the tax would be very broad and uniform.

Low Rates vs. High Rates. Because the base is broad, the rates of a VAT are by definition relatively low. Even a 15% VAT (which would pay for cutting the payroll tax in half, elimination of the corporate tax on net income, and removing from the income tax rolls all but upper middle and high income people) is a much lower rate of tax than is now widely applied to a large number of

---

[2] The nonworking poor, largely welfare recipients and some elderly, would also be compensated. In their cases, any increase in the cost of consumption goods should automatically be offset by a COLA increase in the level of transfer payments they receive.

Americans who do not consider themselves to be rich by any stretch of the imagination.

Taxing Savings Once vs. Taxing Savings Twice. Although a VAT includes in the tax base all forms of output -- including the value produced by use of savings (capital) -- it excludes savings as such from the tax base. The income tax includes in the base both savings as such and the income or value produced by savings.

Single Tax vs. Double Tax. The Committee is familiar with the present double tax on net income initially realized in corporate form (once when earned at the corporate level and again when distributed as a dividend). To the extent that the corporate net income tax is not passed on to consumers through higher prices, it falls largely on capital. Capital purchases of equipment (which really represent savings) are not immediately deductible from corporate net income. There is no deduction for dividends (which represent "wages" (or rents) paid for the use of capital). Dividends are taxed again when received by the shareholder who pays personal income taxes. If a VAT were substituted for both corporate and personal income taxes, the output value of both wages and capital would be taxed once and that single tax would be paid at the corporate or business level. Under a VAT, wages are not deducted from the corporation's output base because the value they represent has not previously been taxed somewhere else in the value-added chain. Dividends (and interest) are also not deducted because the value added by the use of the capital provided by the corporation's shareholders and bondholders has not previously been included in some other VAT base. Purchases of capital equipment are, however, deducted from the base because their value has already been included in some other business's VAT base and previously taxed.

Consistency vs. Inconsistency With U.S. Tax History. A VAT would not be inconsistent with tax history in this country. Prior to 1965, we imposed a broad array of excise taxes. Some were imposed at the retail level and closely resembled sales taxes. Others were manufacturers' excise taxes which contained all the essential ingredients of a VAT -- a tax on the value of specified domestically-produced goods (at least up through the manufacturing stage), a corresponding tax on the importation of those goods, and a type of tax-forgiveness on exports. A VAT is a refined version designed to be more neutral and efficient at home and to help level the playing field abroad.

Consistency vs. Inconsistency With The International Pattern. Once Canada and Japan implement their VATS in the near future, we will be the only major nation that relies primarily on income and payroll taxes that concentrate the burden on our own citizens and retard economic growth more than is necessary per dollar of revenue raised. Consistent with the international pattern, the VAT is imposed on the import of foreign-produced goods, but is rebated on the export of U.S.-produced goods that are sold abroad.

Acceptability vs. Unacceptability to Voters. Substitution of a VAT for income and payroll taxes may make a lot of political sense. On the positive side, voters would welcome another cut in income tax rates. Imagine the dramatic response to cutting in half the payroll tax which is concentrated on low and middle income wage earners and for many is their heaviest tax burden. Given the major mischief caused by the double tax on corporate income and the overriding political wisdom of maintaining prosperity, it makes sense to substitute the VAT for that tax also, especially since corporations will in the first instance be the principal payers of a tax on value added. Despite the differences, many people will equate a VAT with a national sales tax. That is, however, not necessarily a political negative. One recent poll indicates that most people would prefer a national sales tax to an income tax increase for deficit reduction.

Fundamentally, most of us would probably rather have the choice of paying tax when we consume instead of being forced to pay tax when we work and earn income. Another recent poll shows that today most people are even more dismayed by the Orwellian complexity of the income tax than before the tax reforms in 1986. If we could avoid the annual agony of April 15th, most of us might prefer to go the whole way -- raise the VAT to 15% and eliminate the personal income tax except for the upper-middle and high income brackets.

## Conclusion

For a variety of reasons ranging from complexity to less political acceptance of a high-rate progressive income tax in a society where affluence is much more widespread than ever before, we may have come to the end of the era of the income tax as a principal source of revenue. For that reason and because of external changes where we are very much part of a world economy, the idea of substituting a VAT for all or part of income and payroll taxes may at least be worth considering.

Not everyone will agree with all aspects of the analysis of a VAT in relation to existing income and payroll taxes. Some may dispute the fundamental thesis of substitution altogether. Much work remains to be done and it may be that the details of a substitution, particularly the transition from the present system, would be difficult.

While President Bush has flatly rejected raising new revenues by an additional tax on "consumerism" (or any other tax increase for that matter), he has forthrightly acknowledged the merit of philosophical debate about a value-added tax. [WSJ, April 5, 1989.] Open debate may provide the answer to the current quandary: how to eliminate the deficit without a U.S. tax increase that is both politically unpalatable and likely to slow economic growth? Debate may also reveal that a VAT is not necessarily an additional tax on consumers after all.

Chairman ROSTENKOWSKI. Thank you.
Mr. Swanstrom.

## STATEMENT OF THOMAS E. SWANSTROM, CHIEF ECONOMIST, MERCHANDISE GROUP, SEARS, ROEBUCK & CO., ON BEHALF OF THE NATIONAL RETAIL MERCHANTS ASSOCIATION

Mr. SWANSTROM. I am the chief economist of Sears, Roebuck & Co., I am here today representing the National Retail Merchants Association, the Nation's largest trade association for the general merchandise retail industry.

It has often been said if you get four economists together, you will hear four different opinions—or five if one went to Harvard. In recent years the issue of savings seems to be almost unanimous in terms of what economists think about it. However, there is a small but vocal group who believe we do not really have a savings problem in this country. Thus, I have decided to concentrate my testimony on what I feel is by far the most important aspect of the savings issue—demographics.

The most important theory concerning savings was developed by Modigliani. He entitled it the life cycle theory of savings, which means people save for their old age. As shown on chart 1 of my written statement, middle age persons envisioning retirement are high savers while the young and the old tend to dissave.

What has caused the lengthy decline in the savings rate? To get an answer we looked at virtually all of the factors that have been put forth by economists as explanations for savings trends. A statistical analysis showed that only demographics have a significant relationship to the U.S. savings rate. I draw your attention to chart 3 on page 3 of the statement, which shows the close relationship of the high savings, 45- to 69-year age group to the savings rate over time.

What does this strong relationship between the saver group and savings rate imply for the future? As shown on chart 4, page 4 of my written statement, in 1993, the 45- to 69-year-old group will start soaring as a share of the population—25 years and older. At the same time, the 25- to 44-year-olds' share will decline sharply. The demographic impact of those changes will occur between 1995 and 2010. We believe that in 1993 the savings rate will turn around and then accelerate upward. By early in the next century the savings rate will be challenging the peaks of the early 1970's. Therefore, because of demographic influences there is little Congress can do before 1993—short of opening up the immigration floodgates, to raise the savings rate.

Regarding savings, there is another point that I consider a very important aspect of the issue. The argument is that the supposed higher savings rate of other countries, especially Japan, means that the United States has fallen way behind.

You should keep in mind that U.S. per capita savings stocks, not the rates, but the total stock of savings, are actually three times higher than those of Japan. This is due to the accumulation of U.S. savings over time and higher interest rates in the United States. In an intriguing analysis, Kenichi Ohmae, the managing director of McKinsey & Co. in Japan, divided increases in household assets by disposable income for both the United States and Japan. When this calculation is made, the Japanese savings rate of 14.4 percent in the 1980's is actually below the 19.6 percent rate of the United States.

The maturity of the U.S. economy is well evidenced by its investment rate. It is commonly thought that U.S. investment has declined over time. It has not. As a share of GNP, U.S. investment has been stable. The difference is that the investment share of GNP has been accelerating in other countries. What is most important is that the U.S. capital stock per capita is still the highest in the world.

In recent years the savings rate issue has become a "straw man" for those individuals and groups advocating tax increases. What they ignore, however, is that any such tax increase would reduce both consumption and savings. In fact, considering the value added tax, the initial response of consumers to a VAT is likely to be one of maintaining their spending levels by reducing savings. Thus, the savings rate could be severely depressed by a value added tax. In addition, the fall-off in consumption would probably precipitate a recession, since consumers would stock up on goods before the VAT was imposed and then cut their spending sharply.

As the full text of my written statement substantiates, a VAT would not produce what its advocates proclaim: substantially lower deficits, higher savings and improved trade balance. In addition, a VAT has other decided disadvantages, including regressivity, adverse impact of small and growing businesses, and enormous administrative burdens that the Federal Government would impose on business but not pay for.

But the most onerous aspects of the VAT involve its effects upon the political process. This is because a VAT would not be out in the open like most taxes, but would instead be hidden from those who pay for it. The result would be that when money is needed for governmental purposes, raising the VAT would be an easy and painless way for lawmakers to fund these programs. Studies have shown that governments that rely on VATS have significantly higher levels of government spending. The same would happen in the United States as the traditional restraints on spending would loosen considerably and the Federal Government's share of GNP would grow accordingly.

In summary, we believe that demographic changes are the prime determinants of U.S. savings rate and, over the next 20 years, these changes will push the savings rate up sharply. In fact, 10 years from now, the debate is likely to concern savings rates that are too high rather than too low.

As Alan Greenspan has said, "A sharp contraction in the Federal deficit appears to be the only assured source of augmenting domestic net savings." In his testimony before the National Economic Commission, Greenspan stressed that this reduction in the deficit should come from spending cuts, not revenue increases. His reason: the proclivity of Congress to use additional revenues generated by tax hikes to increase spending. We could not agree more.

Thank you.

Chairman Rostenkowski. Thank you, Mr. Swanstrom.

[The statement of Mr. Swanstrom follows:]

National Retail Merchants Association
TELEX—INT'L 220 - 883 - TAUR
TWS—DOMESTIC 710 - 581 - 5380 TPNYK
ATTN: NRMA

NRMA
1000 Connecticut Avenue, N.W.
Washington, D.C. 20036
202/223-8250

# STATEMENT OF
# THOMAS E. SWANSTROM
# CHIEF ECONOMIST
# SEARS, ROEBUCK AND CO.
# AND THE
# NATIONAL RETAIL MERCHANTS ASSOCIATION
# TO THE
# HOUSE WAYS AND MEANS COMMITTEE
# APRIL 19, 1989

Mr. Chairman and members of the Committee, my name is Tom Swanstrom. I am the Chief Economist of Sears, Roebuck and Co. I am here today representing the National Retail Merchants Association ("NRMA"), the nation's largest trade association for the general merchandise retail industry. Our members operate 45,000 leading department, chain, independent and specialty stores in all 50 states. Annual sales of our members exceed $175 billion and we employ more than 3 million workers. NRMA consistently has been a supporter of federal income tax reform and of efforts to reduce the federal budget deficit.

## THE ISSUE

It has often been said that if you get four economists together, you will hear four different views (or five if one went to Harvard). Yet, in recent years there has been one issue that most economists have agreed upon, almost without exception. That is the argument that the United States has a savings problem and special action is needed as a remedy for it. As eighteen leading economists concluded at a Bank Analysts conference last spring: "The slowness in correcting the inadequacy of U.S. domestic savings was the single overriding concern about the U.S. economy and the financial system."

However, there is a small but vocal group who believe that savings trends are predominantly influenced by factors that cannot be controlled by policy actions. Specifically, they believe that savings are closely related to the age distribution of the population. This means that, other than opening up the immigration floodgates, there is nothing that Congress can do to change the demographic influences on the savings rate.

I have available for handout copies of an article that I prepared for Retail Control, a periodical published by the National Retail Merchants Association. In this article I summarize the history of the savings rate, the various savings theories, the different U.S. savings rate concepts, and international savings rate comparisons. These areas are all necessary to fully understand the savings issue. But, in the limited time available for my testimony, I cannot possibly cover all of these facets of savings in the depth they deserve. Thus, I have decided to concentrate my testimony on what I feel is by far the most important aspect of the savings issue – demographics.

*CHART 1*

**DISCRETIONARY SAVINGS BY AGE GROUP**
**- Percent of Income -**

|  | 1980-1981 |
|---|---|
| Under 25 | (5.7)% |
| 25 to 34 | 5.5 |
| 35 to 44 | 5.7 |
| 45 to 54 | 9.2 |
| 55 to 64 | 12.9 |
| 65 and Over | (23.3) |
| TOTAL | 5.8% |

SOURCE: 1980-81 Consumer Expenditure Survey

## SAVINGS THEORY

The most important theory concerning savings was developed by Franco Modigliani in the 1950's. He entitled it the life-cycle theory of savings which, in a nutshell, means that people save for their old age. Thus, middle-aged persons envisioning retirement are high savers while the young and the old tend to dissave.

Such a pattern is shown in Chart 1 which was taken from the 1980-81 Bureau of Labor Statistics Consumer Expenditure Survey. This table shows discretionary savings by age group and fits the life-cycle theory perfectly with the youngest and oldest segments dissaving while the 45 to 64 year olds were strong savers. I should note that more recent surveys have shown different savings patterns that have led some economists to conclude that the life-cycle theory no longer holds. For example, the 1986 Consumer Expenditure Survey showed a negative savings rate for 45 to 54 year olds.

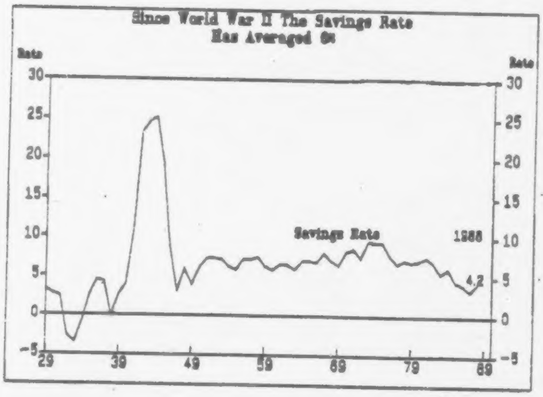
One should keep in mind, however, that compliance with these surveys is voluntary and it is very difficult for interviewers to elicit accurate information on such concepts as savings, wealth, and income from respondents. As you might expect, individuals also tend to have a very difficult time accurately estimating savings flows and increases in wealth.

In addition, a high proportion of respondents refuse to answer questions on such sensitive concepts and this refusal rate is much higher for those with substantial assets. Even those wealthier people who do answer the questions would tend to significantly underestimate the dollars involved. The result is not only extremely poor estimates of savings rates by age but also sharp shifts in such rates from survey to survey.

Since the survey results tend to be very volatile as well as confusing, I believe the best action is to fall back on simple logic. As I mentioned earlier, some economists have taken one survey reading as gospel proof that savings rates do not rise as individuals approach retirement. To me this is akin to flailing at windmills. What makes most sense is that individuals step up their savings as they get closer to retirement and any survey that shows negative savings by such individuals is utter nonsense.

Michael Boskin, the Chairman of the Council of Economic Advisors, also found that demographics were an important factor in savings but he added the after-tax rate of return as another determinant of the savings rate. In his view, tax cuts raise savings and thus the proposed cut in capital gains taxes would be very beneficial to savings.

*CHART 2*



## THE SAVINGS RATE DECLINE

To gain perspective on this issue we decided to analyze historical savings trends and determine what has most influenced savings in the past. Chart 2 shows the U.S. savings rate plotted back to 1929. As you can see, the savings rate has been much more stable since World War II than it was earlier.

During the Depression the savings rate actually turned negative for three years while during World War II it soared as high as 25% when incomes were high and consumer goods unavailable. What the chart doesn't show is the period prior to 1930. Between the Civil War and 1930 the U.S. savings rate was typically quite high and consistently exceeded the savings rates of Germany and Japan. In fact, over most of this period the U.S. had one of the highest savings rates in the world.

The earlier high-savings performance of the U.S. illustrates an important fact often glossed over by savings theorists, namely that savings rates are highest when a country is in its high-growth stage. When a country's economy is growing rapidly, high productivity gains allow both real earnings and savings to move up sharply. It is also at this stage of an economy's life cycle when it most needs investment to sustain growth. Thus, both savings and investment are high when countries are in the transition from a developing to a developed economy.

The other side of this coin is that mature economies require little in the way of savings and investment. Their rapid-growth stage is over and their economies have become too large to grow quickly over long periods.

What bothers economists is that the savings rate was relatively stable in the postwar years until the mid-1970's and then started slipping. By 1987 the savings rate had reached its lowest level (3.2%) since 1947.

## DEMOGRAPHICS AND SAVINGS

What has caused this lengthy decline in the savings rate? To get an answer we looked at virtually all of the factors that have been put forth by economists as explanations for savings trends. Among them were income, wealth, interest rates, spending on energy, inflation, credit, and the trade balance. A regression analysis showed that only two variables have a significant relationship to the U.S. savings rate. One is existing home sales where the relationship was marginally significant. The other was demographics, especially the share of the population in the high-savings 45 to 69 year age group. Demographics proved to be a highly significant predictor of the savings rate.

*CHART 3*

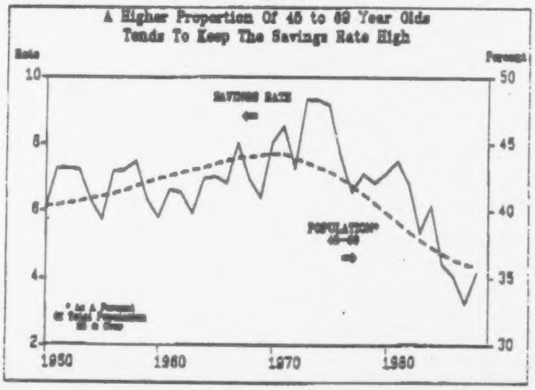
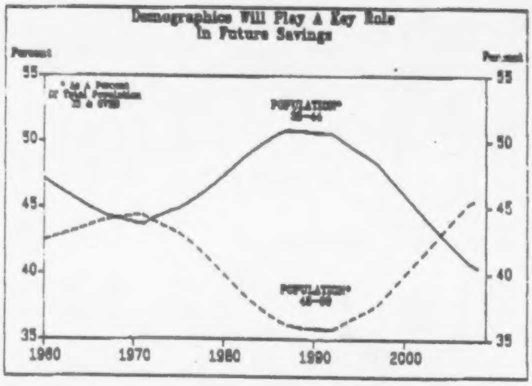


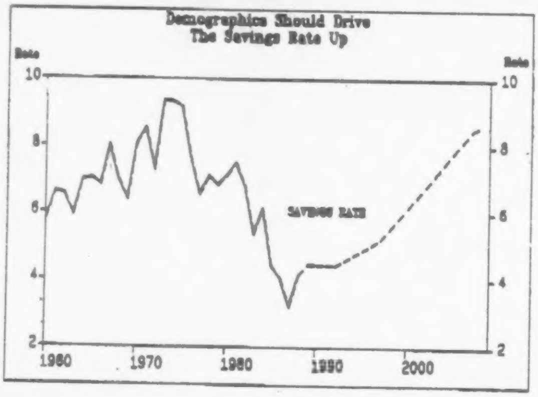
Chart 3 shows well the close relationship over time between the savings rate and the share of the total population (25 years and over) in the high-savings 45 to 69 year age group.

*CHART 4*



What does this strong relationship between the savers group and the savings rate imply for the future? As Chart 4 illustrates, this savers group will grow rapidly in coming years. In 1993 the 45 to 69 year-old group will start soaring as a share of the population (25 years and older). At the same time the 25 to 44 year-olds' share will decline sharply. The major demographic impact of these changes will occur between 1995 and 2010.

*CHART 5*



The impact of these demographic changes on the savings rate are shown in Chart 5. We believe that in 1993 the savings rate will turn around and then accelerate upward. By 2010 the savings rate will be challenging the peaks of the early 1970's. Edward Yardeni of Prudential-Bache and Arnold Moskowitz of Dean Witter have the upturn starting even earlier but agree that the savings rate will rise sharply. Yardeni has calculated that demographics accounted for 68% of the decline of the savings rate during the 1980's and that the influence will be equally dramatic on the upside. For his part, Moskowitz concluded that yuppie savers reached their low point in 1986 but they will rise to a dominant position by the mid 1990's.

## INTERNTIONAL COMPARISONS

Regarding savings, there are also two other points that I consider very important aspects of the issue. One is that the supposed higher savings rates of other countries, especially Japan, mean that the United States has fallen way behind.

*CHART 6*

### RECONCILIATION OF U.S. AND JAPANESE SAVINGS RATES

| | |
|---|---|
| **U.S. Savings Rate** | **4.3%** |
| **Adjusted to International Calculation Standards** | **6.8** |
| **Adjusted for Accounting Inconsistencies** | **10.9** |
| **Adjusted for Socioeconomic Differences** | **14.7** |
| **Japanese Savings Rate** | **16.7** |

**SOURCE: Article by Kenichi Ohmae, Managing Director of McKinsey & Co. in Japan**

In an intriguing analysis, the managing director of McKinsey & Co. in Japan, Kenichi Ohmae, has negated most of the differences between the U.S. and Japanese savings rates. Chart 6 shows the logical flow of his adjustments made to the U.S. savings rate. Starting with a U.S. savings rate of 4.3%, his adjustments for international calculation standards and accounting inconsistencies reduced the savings rate gap from 12.4 to 5.8 percentage points. A further adjustment for socioeconomic differences, such as higher home prices and downpayments in Japan, eliminates most of the remaining gap.

In a further refinement of his argument, Ohmae makes the very valid point that the real issue is not the flow of savings as represented by the savings rate but the actual outstanding stock of savings. On this basis U.S. per capita savings stocks are three times higher than those of Japan. This is due to the accumulation of U.S. savings over time and higher interest rates in the U.S. Ohmae then carries his savings rate analysis one step further by dividing increases in household assets by disposable income for both countries. When this calculation is made, the Japanese savings rate of 14.4% in the 1980's is actually below the 19.6% of the U.S.

## SAVINGS AND INVESTMENT

An additional argument is that, in terms of investment needs, the U.S. does not require as high a savings rate as other countries. This is because structures and equipment are typically lower priced in the U.S. (A factor that would alone reduce the savings rate differential by several points). Also, the U.S. economy is more mature and thus not growing quickly. This reduces the need for investment and, in turn, savings.

The maturity of the U.S. economy is well evidenced by its investment rate. It is commonly thought that U.S. investment has declined over time. It has not. As a share of GNP U.S. investment has been stable. The difference is that the investment share of GNP has been accelerating in other countries. There are many reasons for this, none of which imply that the U.S. has not been pulling its weight. Among these reasons are the spread of technology from the U.S. to the rest of the world and a later shift out of agriculture in other countries.

In the end, this faster investment growth in other countries is a catch-up phenomenon. What is most important is that the U.S. capital stock per capita is still the highest in the world.

## VALUE-ADDED TAXES

In recent years the savings rate issue has become a "straw man" for those individuals and groups advocating tax increases. In their views, low U.S. savings is an intractable problem that can only be solved if consumption can be discouraged through higher taxes. Most of these proponents fall back on value-added or consumption taxes as being the best way to both cut consumption and raise savings.

What they ignore, however, is that any such tax increase would reduce both consumption and savings. In fact, the initial response of consumers to a VAT is likely to be one of maintaining their spending levels by reducing savings. Thus, the savings rate could be severely depressed by a value-added tax. In addition, the fall-off in consumption would probably precipitate a recession since consumers would stock up on goods before the VAT was imposed and then cut their spending sharply.

Many arguments revolve around the supposed isolation of the United States in the value-added tax world spectrum. It is true that the other developed countries (except Australia) now have or are planning a value-added tax. But, in virtually all of these countries the value-added tax simply replaced a similar tax that was often difficult to collect. For example, in Europe the value-added tax replaced manufacturers' cascade turnover taxes while Canada's proposed VAT would substitute for a manufacturer's excise tax.

In contrast, most arguments for a U.S. VAT propose it as an add-on or a new tax and not as a replacement for existing taxes. Admittedly, a few have proposed that the VAT replace (or partially replace) the corporate income tax (or payroll taxes). It is, however, very unrealistic to assume that Congress will sharply reduce or eliminate the corporate income tax. Thus, the concept of a U.S. VAT has to be considered one of a net addition to the U.S. tax structure.

What is interesting is that the VAT proponents give lip service to the role of a VAT in cutting the federal deficit and raising savings. But, what they really want is some of the money. The VAT camp is an unlikely assortment of liberals and conservatives. Some want the VAT to increase social spending; others want it to push up defense spending. Many see the VAT as a way to revive the investment tax credit, while others want it to offset taxes on business. In any case, with the substantial sums of money involved in a VAT, the lobbyists would be out in full force to divvy it up.

One of the supposed prime advantages of a VAT is that, under the rules of GATT, it would be rebatable at the border as an indirect tax. But, with the VAT as an add-on tax, there would be absolutely no benefits to the U.S. trade balance. This is because the prices of U.S. exports at the border after the VAT rebate would be exactly the same as they are now. Imports would have the VAT applied at the border but domestic sales of U.S. manufactured goods would also be subject to the VAT. Thus, again the competitive posture of U.S. goods would be exactly the same as it is now (although demand for both domestic and imported goods would erode due to the higher prices stemming from the VAT).

Thus, a VAT would not produce what its advocates proclaim: substantially lower deficits, higher savings, and an improved trade balance. In addition, a VAT has other decided disadvantages. For one thing any type of consumption tax is very regressive. Low-income families and the elderly would be hit especially hard since their consumption often exceeds their incomes. The VAT would also impact all consumers in terms of its effects upon inflation. When Margaret Thatcher doubled the U.K. VAT a few years ago, the consumer inflation rate also doubled within two years.

Small and growing businesses would also be hurt badly by the VAT since the taxes would have to be paid even if the company was unprofitable. For all businesses a VAT would be another enormous administrative burden that the federal government would require but not pay for. The government itself would, of course, also have to set up a costly new government agency to administer the program. If differential rates were instituted on various categories of merchandise (as is the case in Europe and likely here) these administrative costs would be 50 to 80% higher.

But, the most onerous aspects of the VAT involve its effects upon the political process. This is because a VAT would not be out in the open like most taxes but would instead be hidden from those who pay it. The result would be that when money is needed for governmental programs, raising the VAT would be an easy and painless way for lawmakers to fund these programs. Studies have shown that governments that rely on VAT's have significantly higher levels of government spending. The same would happen in the U.S. as the traditional restraints on spending would loosen considerably and the federal government share of GNP would grow accordingly.

## CONCLUSIONS

In summary, we believe that demographic changes are the prime determinants of the U.S. savings rate and, over the next twenty years, these changes will push the savings rate up sharply. As John Rutledge has aptly said, "Rising savings rates will make the U.S. the Japan of the 1990's with very low inflation and super-low interest rates, rising capital formation, growing productivity and an improving trade situation."

In fact, ten years from now the debate is likely to concern savings rates that are too high rather than too low. Any move to quick fix savings through a value-added tax would only aggravate the situation and create many new problems of its own.

As Alan Greenspan has said: "A sharp contraction in the federal deficit appears to be the only assured source of augmenting domestic net savings." In his testimony before the National Economic Commission, Greenspan stressed that this reduction in the deficit should come from spending cuts not revenue increases. His reason: the proclivity of Congress to use additional revenues generated by tax hikes to increase spending. We could not agree more completely.

Chairman ROSTENKOWSKI. Dr. Thorning.

## STATEMENT OF MARGO THORNING, PH.D., CHIEF ECONOMIST, AMERICAN COUNCIL FOR CAPITAL FORMATION AND DIRECTOR OF RESEARCH, CENTER FOR POLICY RESEARCH

Ms. THORNING. My name is Margo Thorning. I am the Chief Economist for the American Council for Capital Formation and Director of Research for our Center for Policy Research.

Our center has underway a 2-year project called "Public Policy Options to Increase U.S. National Saving," and thus I am particularly grateful for the opportunity to appear before this committee. I commend the committee and its foresight in addressing this issue, which is so vital to our national interest.

I would like to start by taking a quick look at the U.S. savings rate. Historically, U.S. net saving has dropped precipitously from 7.4 percent of GNP over the 1960–80 period, to 2.8 percent in 1988. Federal dissaving is clearly a major factor contributing to our lower savings rate but the decline in private saving is also a significant element.

Another thing to look at is how the United States stacks up compared to the rest of the world. Not only is our rate low historically, but it is also low compared to our international competitors'. Using standardized OECD data, which takes account and adjust for differences in national income accounting procedures, the U.S. savings rate was only 5.3 percent over the 1973–86 period, compared to 10 percent in West Germany and over 18 percent in Japan.

These data are standardized and they take account of the points that Mr. Swanstrom has raised in his testimony, and I believe they are the more accurate presentation of the Japanese versus U.S. saving rates.

Furthermore, low savings rates tend to mean I think, slower productivity growth. Gross domestic product per worker rose by 5 percent in Japan and over the 1960–87 period compared to only 1 percent in the United States.

Why is U.S. savings so low?

Experts believe personal savings is low at least in part due to the double taxes on saving which has already been addressed by Mr. Christian.

Why is business savings so low?

Business saving, most people don't realize, is 30 percent of total private saving. It has also fallen in recent years. It fell during the recession years of 1980–82 but it was climbing again to its traditional 3 percent, so that by 1985 business saving was 3 percent of net national product.

However, since the Tax Reform Act of 1986 it has fallen to 1.9 percent of net national product. A recent study by Dr. James Poterba of the Massachusetts Institute of Technology, predicted that the Tax Reform Act would in fact depress business saving and that seems to be the case. He concluded each $1 decrease in business saving causes a 25 to 50 cents fall in total private saving.

What are the consequences of a low United States savings rate?

A primary consideration should be the cost of capital. Low U.S. savings rates contribute to a high cost of capital that business firms must pay. In other words, hurdle rates on new investments are going to be higher because the cost of capital is higher and fewer investments will be made.

In order to increase productivity, we need to encourage investment in modern equipment, yet the recent Congressional Research Service study shows that the cost of capital for investing in new equipment has risen by 23 percent since the Tax Reform Act of 1981.

Low saving means slow growth and productivity. That, of course, has serious consequences for economic growth. Over the past 15 years our productivity growth has been significantly slower than that of our major competitors.

What are the options for increasing the U.S. savings rate?

One proposal is to eliminate the Federal deficit and try to run a 1-percent surplus, as Chairman Greenspan and ex-FED Chairman Volker have recommended. Such a program, which would require a swing of about $250 billion at 1992 income levels, cannot be achieved solely through cutting spending. While spending cuts should be our first priority, tax increases are inevitable.

The consumption tax, such as a value added tax, should be considered because it has numerous advantages over higher income taxes. It raises $25 billion per point at 1992 income levels. It is less unpopular according to public opinion surveys. The economy would, according to academic studies, grow faster if a value added tax were substituted for part of the income tax, because savings would tend to increase.

A VAT is consistent with the tax systems of our major competitors. Forty six countries, including Japan now employ a VAT.

A VAT could also be used to reduce the cost of capital for equipment. Studies show that a $20 billion allocated toward investment incentives for investment and equipment could reduce the cost of capital by 10 percent.

It could also be used to pay for reinstating the IRA's which recent academic studies have shown did increase saving in the United States.

In conclusion, although spending restraints should be our first priority in order to eliminate the deficit, which is now running at 3 or 4 percent of gross national product, a broad based consumption tax, such as a value added tax, is the best choice for reducing Government dissaving and increasing private saving and investment.

Thank you.

Chairman Rostenkowski. Thank you, Dr. Thorning.

[The statement of Dr. Thorning follows:]

Statement of
Dr. Margo Thorning, Chief Economist
American Council for Capital Formation
and Director of Research
ACCF Center for Policy Research
before the
House Committee on Ways and Means
Wednesday, April 19, 1989

## INTRODUCTION

My name is Margo Thorning. I am chief economist of the American Council for Capital Formation and director of research of our affiliate the ACCF Center for Policy Research. Our Center has underway a two-year "Project on Public Policy Options to Increase U.S. National Saving", with a major public policy symposium on this issue scheduled in Washington, D.C. on October 11-13. I am, therefore, particularly grateful for the opportunity to appear today before this committee to discuss the U.S. saving issue, specifically as it affects U.S. economic growth, productivity, job creation, and the ability of U.S. firms to compete in international markets.

I commend the Ways and Means Committee for its foresight in addressing this issue which is so vital to our national interest. There is a growing national consensus among economists, policymakers, and editorial writers that one of our most serious challenges is to raise the U.S. saving rate. While differences exist on the absolute magnitude of the U.S. saving problem and appropriate public policy remedies to deal with it, there is no disagreement that higher saving rates are essential to U.S. economic security.

## THE U.S. SAVING RATE: HOW DOES IT COMPARE?

### What is Net Domestic Saving?

As defined in the national income accounts, net domestic saving is not a pool of funds; instead it results from the absence of action. Net domestic saving is that portion of national income that is not spent on consumption. It consists of individual saving, or that portion of disposable income which individuals do not spend on consumption; business saving, or increases in retained earnings; and government saving (or dissaving), as represented by a net surplus (deficit) incurred on balance by Federal, state, and local governments.

### The U.S. Saving Rate -- Past and Present

The U.S. saving rate has fallen precipitously in recent years. For our purposes, the key figures are the net domestic saving rates of 1.9 percent in 1986 and 1987 and the 1988 rate of 2.9 percent (see Table 1, page 2.) These levels contrast with a 5.7 percent rate as late as 1981 and an average of 7.4 percent over the two preceding decades. While Federal dissaving is clearly a major factor contributing to lower saving rates in the 1980s, declining private saving is also a significant element.

Although gross private saving in the U.S. has remained fairly constant since the 1950s, net saving (which excludes depreciation charges) has fallen from an average of 8.7 percent in the 1950-1979 period to less than 7 percent from 1980-1986. (See Table 2, page 2.) Since the passage of the Tax Reform Act of 1986, net private saving has fallen to 4.9 percent, a drop of 44 percent over the three preceding decades. The importance of corporate saving is also highlighted by Table 2. Over the past four decades, corporate saving accounted for about 30 percent of total private saving.

Table 1: Flow of U.S. Net Saving and Investment
(Percent of GNP: national income accounts basis)

| | Average 1960-1980 | 1981 | 1986 | 1987 | 1988 |
|---|---|---|---|---|---|
| Net Private Domestic Saving | 8.0 | 6.6 | 5.3 | 4.3 | 4.7 |
| State & Local Government Surpluses | 0.4 | 1.1 | 1.4 | 1.0 | 1.2 |
| Subtotal | 8.4 | 7.8 | 6.8 | 5.3 | 5.9 |
| Less: Federal Budget Deficit | -1.1 | -2.1 | -4.8 | -3.4 | -3.0 |
| Net Domestic Saving Available for Private Investment | 7.4 | 5.7 | 1.9 | 1.9 | 2.9 |
| Plus: Net Inflow of Foreign Saving[1] | -0.4 | -0.3 | 3.4 | 3.5 | 2.9 |
| Net Private Domestic Investment | 6.9 | 5.3 | 5.3 | 5.4 | 5.8 |

Source: Department of Commerce Bureau of Economic Analysis, National Income Accounts. Update prepared by The American Council for Capital Formation Center for Policy Research.

[1] In the 1960-1980 period, and in 1981, the U.S. sent more capital abroad than it received from others: thus the net inflow was negative during this period.

Table 2: Gross and Net Saving Rates, 1950-1988

| | Gross saving (percent of GNP) | | | Net saving (percent of NNP) | | |
|---|---|---|---|---|---|---|
| Year | (1) Corporate | (2) Personal | (1+2) Private | (1) Corporate | (2) Personal | (1+2) Private |
| 1950-59 | 7.4 | 8.7 | 16.2 | 3.0 | 5.2 | 8.2 |
| 1960-69 | 8.3 | 8.3 | 16.6 | 3.8 | 5.1 | 8.9 |
| 1970-79 | 8.1 | 9.5 | 17.6 | 2.7 | 6.2 | 8.9 |
| 1980-86 | 8.7 | 8.7 | 17.4 | 2.1 | 4.8 | 6.9 |
| 1987-88 | 8.3 | 6.6 | 14.9 | 1.9 | 3.0 | 4.9 |

Source: James M. Poterba, "Tax Policy and Corporate Saving." National Bureau of Economic Research, Reprint No. 989, Update prepared by American Council For Capital Formation Center for Policy Research.

## U.S. Saving vs. Our Major Competitors

U.S. saving rates are considerably lower than those of our major competitors, according to data compiled by the organization for Economic Co-Operation and Development (OECD). Net U.S. saving averaged only 5.1 percent of Gross Domestic Product (GDP) over the 1973-1986 period compared to 10.3 percent in West Germany and 18.6 percent in Japan (see Table 3 page 3.) Total saving (private and government saving plus depreciation charges) was only 18.0 percent of GDP in the U.S. during the 1973-1986 period, substantially below Japan's 31.8 percent and Germany's 22.2 percent.

Recent press reports attempting to downplay the differences between U.S. personal saving rates and those of other countries are often inaccurate. For example, Kenichi Ohmae, managing director of McKinsey and Co. in Japan, has tried to make the case that after certain adjustments are made, the Japanese and U.S. saving rates are almost identical. Such analysis is misleading because the OECD data used in Table 3 are standardized to eliminate differences, in national income accounting procedures among individual countries: the data show that U.S. saving and investment rates are far below Japan's and those of other countries with which we compete internationally (see Table 3, page 3.)

Table 3: Saving and Investment as a Percent of Gross Domestic Product, 1973-1986

| | United States | Canada | Japan | France | West Germany | United Kingdom |
|---|---|---|---|---|---|---|
| SAVING | | | | | | |
| Net Saving[1] | 5.3% | 9.4% | 18.6% | 9.0% | 10.3% | 6.5% |
| Personal Saving[2] | 6.0% | 7.8% | 13.2% | 11.9% | 8.1% | 4.7% |
| Gross Saving (net saving plus consumption of fixed capital)[3] | 18.0% | 20.8% | 31.8% | 21.4% | 22.2% | 18.4% |
| INVESTMENT | | | | | | |
| Gross Non-Residential Fixed Capital Formation | 13.6% | 15.9% | 23.8% | 14.6% | 14.6% | 13.9% |
| Gross Fixed Capital Formation | 18.3% | 21.8% | 30.1% | 21.3% | 20.8% | 17.6% |

Source: Derived from National Accounts, Vol. II, 1974-1986 (1973 data from 1973-85 ed.) Organization for Economic Co-Operation and Development (OECD), 1988 ed. Prepared by the American Council for Capital Formation Center For Policy Research, August 1988.

[1] The main components of the OECD definition of net saving are personal saving, business saving (undistributed corporate profits), and government saving (or dissaving). The OECD definition of net saving differs from that used in the National Income and Product Accounts published by the Department of Commerce primarily because of the treatment of government capital formation.

[2] Personal saving is comprised of household saving and private unincorporated enterprise.

[3] The main components of the OECD definition of consumption of fixed capital are the capital consumption allowance (depreciation charges) for both the private and the government sector.

## CAUSES OF LOW UNITED STATES SAVING RATE

### Personal Saving

Personal saving in the United States has fallen in recent years, contrary to the expectations of many experts who believed that lowering marginal tax rates in 1981 and 1986 would stimulate higher levels of saving. Several factors have contributed to the decline of personal saving.

First, people born after the depression of the 1930s are saving smaller shares of their incomes than did their parents at similar ages. Had the post-depression generation "saved like their parents," according to the Chairman of the President's Council of Economic Advisers, Dr. Michael Boskin, the ratio of saving to GNP would have been about 10 percent higher and GNP itself would have been 7 to 10 percent higher by 1980.

Second, numerous features of the U.S. tax code tend to encourage consumption and discourage saving. For example, consumption today costs less in terms of foregone future income because income is taxed before it can be saved. If income which is saved were exempt from tax, the cost of current consumption compared to what could be consumed in the future would rise and the incentive to save would be strengthened. The Tax Reform Act of 1986 (TRA) further exacerbated the bias against saving by increasing the capital gains tax rate.

Third, the existence of Social Security may reduce personal saving since individuals believe the government is "saving for them." Unfortunately, as Stanford University's John Shoven points out, the "pay-as-you-go" nature of Social Security means that what appears as wealth to the elderly does not create wealth or increase capital formation in the U.S. economy because the funds now being paid into the Social Security Trust Fund are being used to fund current government outlays.

Fourth, the stock market boom of the 1980s and the surge in housing prices over the past 15 years may have reduced personal saving rates. Many Americans may have felt a diminished need to save because of the increased value of their equity holdings. Similarly, many families may have reduced their saving in response to the dramatic rise in the value of their houses. When large numbers of houses whose values have appreciated sharply come on the market, or investors realize gains, huge profits do arise. But capital gains realized by the sellers affect neither personal income nor personal saving because capital gains are not included in the NIPA since these gains do not represent income from current production.

## Business Saving

Like personal saving, business saving has trended down as a share of net national product (NNP) in the 1980s. Since the passage of the Tax Reform Act of 1986, business saving has declined to a record low of 1.9 percent of NNP (see Table 2, page 2.)

A recent study by Dr. James M. Poterba of the Massachusetts Institute of Technology on the impact of TRA on corporate saving in fact predicts the Act will depress corporate saving. According to Professor Poterba, the Tax Reform Act of 1986 affects corporate saving in at least three ways. First, it raises average corporate tax rates and thereby reduces after-tax income available for either dividends or retained earnings. Second, it changes the tax treatment of dividends, it makes them more attractive relative to capital gains because dividends are taxed at lower rates and capital gains at higher rates. While Dr. Poterba does not analyze all the provisions of TRA, he states that tax reform's reduction in investment incentives raises the tax burden on new investment and may further reduce corporate saving. His analysis shows that TRA could reduce corporate saving by $36 billion in 1989, or more than 1 percent of NNP. Finally, Dr. Poterba concludes that TRA will reduce total private saving because decreases in corporate saving (due to the $120 billion tax increase) will not be fully offset by increased personal saving. For each $1 decrease in corporate saving, total private saving will fall by 25 cents to 50 cents.

## Federal Deficits

Federal deficits, which have averaged 3 percent of GNP for close to a decade now, have been at the top of the policy agenda for most of that time (See Table 1, page 2.) Federal dissaving (the deficit) in 1988 offset almost half of the saving attributed to individuals, businesses, and state and local governments. Unfortunately, the outlook is for continued large Federal dissaving in the years ahead. This is especially true if the emerging surpluses connected with Social Security are excluded from budget computations (as most economists would recommend).

A recent study by George N. Hatsopoulos, founder, chairman and president of Thermo Electron Corporation, chairman of the Federal Reserve Bank of Boston and a director of the ACCF Center for Policy Research, and Paul R. Krugman and James M. Poterba, professors at the Massachusetts Institute of Technology, compares the major components of Federal spending as a percent of net national product in the period 1970 to 1979, contrasted with 1985 to 1987 (See Table 4, page 5.) They found that direct government purchases rose by 10 percent, mostly as a result of increased defense spending, and that transfer payments increased by almost 20 percent. Net domestic interest increased by 130 percent because of the accumulation of deficits in the 1980s and partly because real interest rates are higher now than in the past. This last point implies not only that we are now paying for past sins but also that the budget deficit is affected by the level of interest rates which, in turn, is affected by the level of national saving. Thus, an improvement in national saving can, per se, improve the Federal deficit.

Table 4: Federal Spending and Revenue 1970-1987
(As percent of net national product)

| | 1985-1987 | 1970-1979 | Difference |
|---|---|---|---|
| Direct Purchases and payment to foreigners | 10.6 | 9.6 | 1.0 |
| Plus transfers to persons | 10.1 | 8.5 | 1.6 |
| Plus net domestic interest | 3.0 | 1.3 | 1.7 |
| Plus intergovernmental grants and other | 3.4 | 3.8 | (0.4) |
| Total outlays | 27.1 | 23.2 | 3.9 |
| Less revenue | 22.2 | 21.3 | 0.9 |
| Equals deficit | 4.9 | 1.9 | 3.0 |

Source: George N. Hatsopoulos, Paul R. Krugman, and James M. Poterba, "Over-consumption: The Challenge to U.S. Economic Policy." Jointly sponsored by the American Business Conference and Thermo Electron Corporation, March 1989.

## THE CONSEQUENCES OF THE LOW U.S. SAVING RATE

### Short-Run Risks

- Cost of Capital

Many experts conclude that the high cost of capital in the United States is the most important cause of low investment rates, which in turn are a major explanation of lagging U.S. productivity and competitiveness.

What do these costs consist of, and why are they so important to capital formation and productivity growth? Capital costs can be viewed as the total cost of financing an investment, including the purchase price of the asset, depreciation, the cost of the debt or equity funding required for the project, the impact of inflation, and the level of taxation of the income that will flow from the investment when it comes to fruition.

The importance of capital costs to a firm's investment decisions can best be understood in terms of the so-called "hurdle rate," an internally set level of return which new investment projects are required to meet, else the company will not undertake them. The higher the cost of capital to the firm, the higher the hurdle rate. In addition, since "time is money," higher capital costs mean that short-term projects will be favored over those of longer duration, despite the fact that longer-term projects may add the most to productivity.

The level of capital costs is therefore crucial to the level of investment per worker, which in turn strongly affects productivity growth, competitiveness, and living standards. The capital costs of investment in equipment are especially important. In contrast to business investments such as structures and inventories, investment in equipment is right at the cutting edge of our competitiveness problem. This is because, given our high wage levels, our ability to compete abroad in terms of wages is limited. Instead, U.S. competitiveness must flow from increases in productivity. For productivity to increase, we must maintain a high and sustained level of investment in modern, state-of-the-art machinery and equipment.

Given the crucial importance of investment in equipment, one would expect that public policy in this country would be designed to get those capital costs low and keep them there. But this has not been the case. In fact, a recent Congressional Research Service study shows that Federal tax policy increased the capital cost of investing in equipment in this country by about 23 percent from 1981 through 1986.

- Flight of Foreign Capital

The decline in the U.S. saving rate in the 1980s has been offset by a shift from a balance-of-payments surplus, in which we were gradually increasing our stock of overseas assets, to a balance-of-payments deficit, in which 60 percent of net investment in the United States is financed by borrowing from abroad. The saving decline has forced the U.S. to rely on foreign lenders and investors for hundreds of billions of dollars ($417 billion from 1985 to 1987) and to reduce net domestic investment by 2 percentage points relative to the 1970s.

As the study by Dr. Hatsopoulos and Professors Krugman and Poterba concludes, if foreign capital flows were to dry up, the ensuing reduction in our national income could be substantial. Most estimates suggest that capital inflows are currently allowing the U.S. economy to live 5 percent or more beyond its means. That means that a cutoff of capital flows would force the United States to make a sudden adjustment comparable in size to that forced by the energy crises of 1973 and 1979 combined. The result could easily be a recession induced by the efforts of the Federal Reserve to control inflation, with an associated loss to the economy considerably greater than 5 percent.

- Trade Deficit Impact

Our low saving rate is the main cause of the trade deficit which has loomed so large in recent years. This is best understood if we recall what we learned in Macroeconomics I: In any period total saving and total investment are always equal. This is true by definition; it is a tautology, but a very useful one.

For example, in recent years total net private domestic investment in the U.S. has exceeded net domestic saving by more than $100 billion per year. The equality of saving and investment has been sustained only by importation of saving from abroad as noted above. But remember that the balance of payments is a double-entry bookkeeping system that always must balance. It has only two basic accounts, goods and capital. Therefore, a capital account in strong surplus (as ours has been) must be accompanied by a goods account that is in heavy deficit.

The major reason for our trade deficit is therefore not unfair trade abroad, weak management, or poor quality of workmanship. It is instead the shortage of domestic saving relative to total investment. In addition, lack of understanding that the shortage of domestic saving causes the trade deficit can lead to strong protectionist policies in the United States. If that happens, a trade war could erupt. The results might well be disastrous from an economic standpoint.

## Long-Run Risks

- Slow Productivity Growth

Low national saving translates into a low rate of investment and slow productivity growth. The extent of our problem is indicated by the fact that, from 1973 to 1987, productivity in U.S. manufacturing grew by only 2.5 percent annually; this contrasts with 3.2 percent in the United Kingdom and West Germany, and 5.3 percent in Japan. This overall poor performance prevailed despite what is surely a temporary spurt in U.S. manufacturing productivity in the early 1980s. Though investment can be financed for a time through foreign borrowing, the U.S. economy eventually must pay its own way, which means that the ability to invest is constrained by the willingness to save.

This investment squeeze can be postponed for a time to the extent that the United States can continue to attract inflows of foreign capital. But these inflows carry their own cost: An increasing share of U.S. assets end up being foreign-owned, implying that in the future a growing share of U.S. output will be claimed by foreigners. This will require real transfers of resources abroad; the result will be slower growth in living standards for our children and grandchildren.

### • Jobs, Growth, and World Leadership

Few would disagree that U.S. industry has lost its pre-eminence in international markets in recent years. To many observers, our huge trade deficits, and the accompanying build-up in foreign ownership of U.S. assets, are symptoms of a failure of U.S. economic policy. Even more important, however, is the lagging growth in relevant measures of the well-being of the American people. For example, real median family income peaked in 1973 and has only recently returned to its 1973 level. Further, the real income of adult male workers has also failed to regain its 1973 peak.

These figures tell us that the standard of living of the American people, which grew so rapidly from the end of World War II until the early 1970s, is in danger of stagnating. At the same time, the living standards among our industrial competitors have grown apace. While our standard of living is still the highest among major nations, unless our productivity and competitiveness are shored up substantially, we will sooner or later fall back to the second tier of major nations in producing the goods and services that their citizens want and need. The consequences of this second-rate performance will not be confined to our own borders; our effectiveness as a Free World leader in security and economic development will also be jeopardized.

## STRATEGIES FOR INCREASING THE SAVING RATE

Several things can and should be done to bolster saving by individuals and businesses, but they are difficult to implement and slow to take effect. The quickest and surest route to a higher domestic saving rate is to reduce the deficit in the Federal budget. As mentioned earlier, Federal dissaving (the deficit) in 1988 offset more than half of the saving attributed to individuals, businesses, and state and local governments (See Table 1, page 2.) Unfortunately, the outlook is for continued large Federal dissaving in the years ahead. This is especially true if the emerging surpluses connected with Social Security are excluded from budget computations. Long-run growth in the U.S. would be faster if Social Security surpluses were used to reduce the total federal debt rather than to fund current consumption as is currently practiced.

### Federal Deficit Reduction Goals

A strong case can be made for rejecting mere balance as the budget goal and for striving instead for an annual surplus of about 1 percent of GNP as recommended by Federal Reserve Chairman Alan Greenspan and his predecessor Paul A. Volcker. As Uncle Sam becomes a net lender and retires securities, rather than selling more, credit markets will strengthen and pressures on interest rates will decline. Since our large Federal deficit is strongly expansive to the economy, the Federal Reserve is forced to follow a stingier-than-otherwise monetary policy -- in effect offsetting the fiscal expansiveness. A surplus in the budget would give the Federal Reserve much more flexibility in managing monetary policy.

Realization of an annual surplus of an additional percentage point in the Federal budget would, other things being equal, add an additional percentage point to our low domestic saving rate. Our trade position would tend to strengthen. In addition, the goal of a 1 percent surplus could replace the balanced budget as the benchmark of fiscal responsibility for the administration and Congress.

If today's structural Federal deficit (excluding the Social Security surplus) is about 4 percent of GNP, then the size of the total effort comes to 5 percent of GNP (4 percentage points to remove the deficit, another percentage point to establish the 1 percent surplus). In current dollars, the amount of swing is a whopping $250 billion per year (4 percent of GNP of $5.1 trillion).

While spending restraint should be accorded first priority in deficit reduction, it is an inescapable fact that a swing of $250 billion per year in the Federal budget is all but impossible without a significant tax increase. The only alternatives are either decimation of the defense budget, or sharp (and politically undoable) cuts in Social Security and Medicare. From a political standpoint, a workable approach might be a five-year budget plan that would split the deficit reduction task evenly between spending restraint and tax increases, or $125 billion per year for each. Spending goals would be met by slowing the rate of increase in Federal spending relative to potential GNP. On the tax side, it is clear that new sources of revenue will have to be sought.

## A Broad Based Consumption Tax

A broad-based consumption tax, such as a value added tax (VAT) has several advantages over other types of tax increases for deficit reduction and for enhancing saving and investment incentives. It is a powerful revenue raiser, providing more than $25 billion per point per year (in 1992) if broadly applied. Surveys show that it is the "least unpopular" tax, the tax people prefer to pay if they must pay more. Participants in the underground economy would be hit by a VAT. Recent academic studies indicate that the U.S. saving rate and capital stock would grow much faster if we substitute a value added tax for part or all of the income tax.

A VAT is also more consistent with tax systems used by our trading partners around the world--forty-six countries including Japan now have a VAT; and Canada is debating one. And the VAT can be structured so as to hit consumption primarily rather than the saving and investment that deficit reduction is supposed to encourage.

### • Cost of Capital Impact

If part of the VAT revenues are used to enhance business incentives to invest in productive equipment, the capital cost of that investment will decline significantly and U.S. competitiveness will be strengthened. For example, if $20 billion of the revenues from a VAT were used to pay for a 5 percent investment tax credit for equipment, the user cost of capital for equipment would decline by close to 10 percent, according to estimates by Laurence H. Meyer and Associates, an economic consulting firm.

### • Personal Saving Impact

As Harvard professor Lawrence Summers observed in a recent a Tax Notes article; "While there can be no question that reducing Federal deficits is the most potent and reliable way of increasing the national saving rate in both the short and long run, there is some scope for other policies to affect the level of national saving."

There is a large body of economic research, including that of Harvard Professor Summers and Stanford Professor John Shoven, who also are directors of our Center for Policy Research, suggesting that savers do respond positively to higher after-tax rates of return. In my judgment capital gains taxation, IRAs and Keoghs, and other tax provisions can affect our saving rate. Last week, my colleague, Mark Bloomfield, the president of the American Council for Capital formation and our Center for Policy Research testified before this committee on the positive impact of the President's capital gains tax reduction initiative on U.S. saving. Today I would like to comment on the debate over the significance of IRAs for personal saving.

In the opinion of Professor Summers and other tax policy experts, the partial revocation of IRAs was unfortunate because the widespread conviction that IRAs are ineffective in stimulating saving is not supported by the available evidence. While the officially measured personal saving rate has declined since 1981, this should not be taken as evidence that IRAs did not have a substantial impact on saving decisions. Many other factors affecting the saving rate have changed since 1981, so that any positive effect IRAs might have has been masked. Reduced corporate pension contributions, increased consumer borrowing, and renewed consumer confidence all are possible explanations for the low saving rate. Without the enactment of IRAs, the saving rate might well have fallen even further.

The weight of the available evidence suggests that IRAs generate a significant amount of saving that would not otherwise have taken place. Under current law, if IRAs were reinstated, the government would lose about 25 cents for each dollar of contribution according to Professor Summers. If more than one-fourth of the money contributed to IRAs represents new savings, IRAs will increase private saving by more than their revenue cost. If this condition is met the case for maintaining IRAs is clear. Even if it is not, there is still a strong case for saving incentives given that restoration of IRAs would be likely to come at the expense of other tax breaks rather than larger deficits. The cost of reinstating IRAs could be offset with revenues from a Federal VAT.

## CONCLUSIONS

Although Federal spending restraint should be accorded the first priority in the deficit reduction required to increase net national saving, it is an inescapable fact that a swing in the budget from the current on budget deficit of 4 percent to an annual surplus of 1 percent -- some $250 billion per year -- is all but impossible to achieve without a significant tax increase. A tax increase which burdens personal and business saving would be the fiscal equivalent of running in place, if the goal is to raise the national saving rate. The addition of a broad-based consumption tax such as a value added tax to our current tax system would be less harmful to the private saving rate than higher income taxes.

The VAT can be described as a solution in search of a leader. A few members of Congress have touted a VAT; many more support it in private. But the fact is that in our system so radical a step in taxation cannot occur without the concerted and strong leadership of the president of the United States and joint congressional leadership.

If and when such leadership is forthcoming, then the VAT could become the key element in a bold program to help raise this nation's alarmingly low saving rate.

Chairman ROSTENKOWSKI. Mr. McIntyre.

## STATEMENT OF ROBERT S. McINTYRE, DIRECTOR, CITIZENS FOR TAX JUSTICE

Mr. McINTYRE. Thank you, Mr. Chairman.

I think most of us agree that the savings shortfall in this country is a real problem. It has produced the highest real interest rates in the postwar era. It has led to our huge dependence on foreign lenders and is really the root cause of our trade deficit. It has sapped our ability to make the public and private investments that we need for the future.

One thing to keep in mind is that a shortfall of savings is a very new phenomenon for this country. Until the 1980's we had surplus of savings in most years averaging about four-tenths of the GNP. We invested that surplus overseas. Now, however we have a savings shortfall. You have to look and see where it comes from.

There is a table on page 2 of my testimony that shows that private savings is still more than enough to pay for domestic investment in this country, although it has declined slightly. Thus, the Government deficit is the root cause of our savings shortfall. If it weren't there, we would still be in a saving surplus situation.

Now, what caused the budget deficit?

Some people say it is excess spending. But if you look at the real data what you find is that spending as a share of the GNP on everything but interest has declined during the 1980's. That is, once you take out Social Security—which, of course, is paid for, more than paid for. So we have a declining Government spending side, but what we have on the tax side is an even bigger decline. That is the root cause of our budget deficit and our savings shortfall.

But as has been pointed out earlier, it is not tax cuts for most Americans that caused the deficit. Indeed, most Americans had their taxes increased in the 1980's, yet we have a tax shortfall. How can that be?

It can be because the people in this country who make most of the money have seen their taxes go down dramatically—by 25 percent for the richest 1 percent. Ironically, those tax cuts were supposedly going to increase savings. That is why they were enacted. The theory was, we were told then, that if we cut taxes for wealthy individuals they would save more. The economy would do better and we would run a budget surplus by 1984. Well, it didn't work out that way. Personal savings actually declined after the tax cuts.

That makes sense when you think about it. The theory that higher rates of return lead to higher personal savings was never very strong to start with, but was proven pretty wrong by the experience in the eighties. Pension funds are a good example. Pension funds are saving money for workers' retirement. When the stock market boomed, companies didn't have to put more money into the pension funds and they didn't. As a result, pension fund contributions declined dramatically as a share of the GNP. Just from 1981 to 1985, they fell by over a third. Personal savings declined by about the same percentage over that same period.

We have got a mess on our hands. We have a big shortage in savings, the first time that has happened in our memory, since World

War II. We have to have to deal with it. Now, the architects of the past policy are going to come before you and say, "You know what we need to do? We need to repeat what we did in the past." They are wrong. Some of them say—the President for instance—that we need more tax cuts for the wealthy. "That is the answer," they say. Well, welcome to 1988, President Rip Van Winkle. We tried that. It didn't work.

Then you have the flip side of the Reagan-Bush policy. "Well, if tax cuts for the rich aren't the answer," say some, "How about a soak the poor policy? Let's raise excise taxes through the kazoo; let's have a VAT. If we hit the poor hard enough, we will increase our savings." That is wrong, too.

The real question we are looking at here is not whether we want to cut consumption. We do. We must have a shift toward savings. The question is whose consumption do we want to cut? Do we want to make it harder for millionaires to buy their second Mercedes or for middle-income people to buy a Plymouth?

Past policies did not promote savings, in fact they discouraged it. They promoted consumption by the people who got the tax cuts—the rich. So, in conclusion, yes, we need a tax increase. We need a big tax increase. But it should fall on the people who have had the party for the last 8 years at the expense of the rest of us.

Thank you, Mr. Chairman.

[The statement of Mr. McIntyre follows:]

**CTJ** Citizens for Tax Justice

**OFFICERS**
**Ira Arlook**, President
Ohio Public Interest Campaign
**Gerald W. McEntee**, Vice President
American Federation of State, County and Municipal Employees
**William Hutton**, Secretary
National Council of Senior Citizens
**John Sweeney**, Treasurer
Service Employees International Union

**BOARD OF DIRECTORS**
**Virginia Abbott**
League of Women Voters
**Morton Bahr**
Communications Workers of America
**Owen Bieber**
International Union, UAW
**Al Bilik**
Public Employee Department, AFL-CIO
**Kenneth T. Blaylock**
American Federation of Government Employees
**Jeff Blum**
Pennsylvania Public Interest Campaign
**Steve Brobeck**
Consumer Federation of America
**William Bywater**
International Union of Electronic Workers, IUE
**Joan Claybrook**
Public Citizen
**Wayne Cox**
Minnesota CTJ
**Bob Creamer**
Illinois Public Action Council
**John DeConcini**
Bakery, Confectionary and Tobacco Workers
**Larry Dugan**
International Union of Operating Engineers
**Jeff Eagan**
Wisconsin Action Coalition
**Faith Evans**
Office for Church in Society, United Church of Christ
**Robert Georgine**
Building and Construction Trades Department, AFL-CIO
**Lenny Goldberg**
California Tax Reform Association
**Elena Hanggi**
ACORN
**Benjamin Hooks**
National Association for the Advancement of Colored People
**Blair Horner**
Public Interest Research Group
**Lane Kirkland**
AFL-CIO
**Carolyn Lucas**
Massachusetts Fair Share
**Howard Samuel**
Industrial Union Department, AFL-CIO
**Albert Shanker**
American Federation of Teachers
**Tom Swan**
United States Student Association
**Linda Tarr-Whelan**
National Center on Policy Alternatives
**Robert M. Tobias**
National Treasury Employees Union
**William Winpisinger**
International Association of Machinists
**William Wynn**
United Food and Commercial Workers

**STAFF**
**Robert S. McIntyre**
Director
**Margaret H. Marr**
Policy Director
**David Wilhelm**
Midwest Director
**Jonathan M. Crystal**
Policy Analyst
**Veronica Gibson**
Office Manager

1311 L Street NW
Washington, DC 20005
(202) 626-3780

## Statement of Robert S. McIntyre
## Director, Citizens for Tax Justice
### Before the House Ways & Means Committee
### Concerning Long-Term Issues Relating to National Savings
### April 19, 1989

Over the past decade, something very troubling has been going on in this country. The quintessentially American hope and expectation that each generation will be better off economically than its parents has not only been put on hold for most members of the current generation, it has been systematically undermined for the next generation as well.

Increasingly, more and more of our nation's wealth [illegible] being dissipated, as we borrow against tomorrow to pay for current spending. We are becoming less and less able to pay for the investments we need—both private and public—to improve our standard of living and our children's in the future.

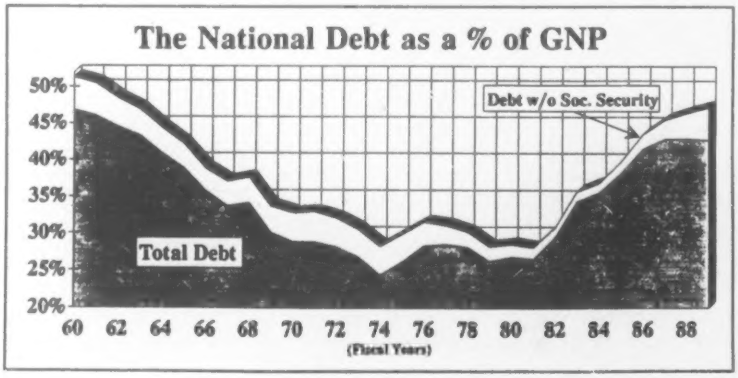
The primary culprit in creating this problem is the federal government and its newly-adopted policy of borrow and spend. For the first eight years of this decade, federal borrowing averaged 4.4 percent of the gross national product, by far the highest sustained level outside of wartime in our nation's history. As a result, we have saddled ourselves and our children with an additional $1½ trillion in debt, a large share of which is owed to foreign investors.

The radical build-up of government debt in the 1980s is a sharp break from the past. Although budgets have rarely been completely balanced, every post-World-War-II administration until the last one succeeded in reducing the national debt as a share of the gross national product.

Coinciding with the growth in the deficit has been a sharp redistribution of income in favor of the wealthy. Indeed, this growth in inequality—and the strident, often self-righteous unwillingness of those who enjoy new-found riches to pay taxes on their enormous gains—underlies most of the government's deficit problem.

Our nation's job is not an easy one. Powerful interests that have benefited from the borrow and spend policies of the 1980s have become even more powerful as a result. They will continue to resist the idea that the government must pay for what it spends, because they know full well that they are the ones who are the cause of the government's failure to do so. As a last resort, they will try to send the bill to the middle- and low-income families of America.

But the assertion that more inequality is what this country needs is dead wrong. Addressing inequality is the only fair way, and probably the only politically conceivable way, to reduce the deficit and begin to recover from the irresponsible binge of the past decade. We as a nation need to act, before we have mortgaged our future so badly that we cannot recover.



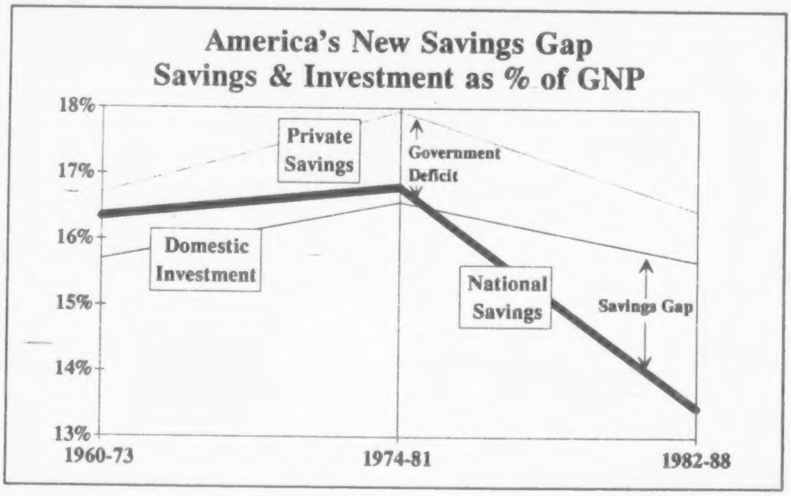
2

## Why Savings Are Down & Why It Matters

National savings is the amount of money that Americans set aside to devote to private investment rather than current consumption. It's the sum of what people and businesses save, less the amount (if any) that government borrows to pay for its programs. If there were no net outflow or inflow of savings to or from abroad, gross national savings would precisely equal gross domestic business investment. Thus, savings pays for a part of our total national output of goods and services—the part of labor and capital that goes into producing new business equipment, buildings and other capital goods or expanding business inventories.[1]

Throughout most of the post-World-War-II era, the United States enjoyed a savings surplus. From 1960 to 1981, total national savings exceeded total domestic investment in every year except for 1971, 1972, 1977 and 1978—and the gaps in those years were very small. Overall, national savings exceeded domestic investment by an average of 0.4 percent of the gross national product from 1960 to 1981. Those surpluses were invested in overseas capital projects.

Since 1981, however, our nation has suffered a chronic savings gap, averaging 2.7 percent of the GNP. A lack of private saving is not the underlying source of the problem. Private savings has continued to be more than enough to pay for domestic business investment during most of the 1980s. In fact, private savings exceeded domestic investment by 0.8 percent of the GNP during the 1982-88 period, not significantly different from the 1.1 percent private savings surplus from 1960 to 1981.[2]



The fundamental cause of the savings shortfall is the federal government's budget deficit. Even including state and local budget surpluses, overall government deficits averaged 2.3 percent of the GNP from 1982 to 1988, far higher than the 0.7 percent of GNP they averaged from 1960 to 1981.

Should we care if we have a shortage of savings in our country? Absolutely. If national savings are insufficient to pay for domestic investment, then interest rates will rise (thereby crowding out some investments) or we will have to borrow the money to finance investments from foreign lenders—or both, as has actually been the case. Real interest rates in the 1980s have been at record levels, as has been our rate of borrowing from overseas. One result is that gross private domestic investment has declined somewhat—from 16.6 percent of the GNP over the 1974-81 period to 15.7 percent of the GNP from 1982 to 1988. Public investment has been squeezed much more significantly. Both these results, along with the huge foreign debt burden we have built up, will result in lower living standards in the future.

---

[1] Generally, investments in "human capital"—e.g., education—are not treated as investments in the national income and product accounts, but as current consumption.

[2] Private savings did dip below domestic investment in 1987 and 1988, only the fourth and fifth times that has occurred since 1960.

## The Trade Deficit

Various people have pointed to a variety of reasons why America now runs huge, chronic trade deficits. Poor corporate management, an insufficiently skilled and educated labor force, decay in the public infrastructure and so forth all have been blamed at one time or another as the source of our woes.

No doubt we could do better in all of these areas. But the overwhelming direct cause of our trade deficit is our shortfall in national savings—a shortfall caused by the government's excessive borrowing over the past eight years.

The arithmetic is very straightforward. When Americans buy foreign products, the dollars that foreigners receive can only be used for two things: (a) to buy American products or (b) to invest in American assets (usually financial assets). As long as the government needs to borrow $120 billion or so each year to finance its deficit, and as long as private savings in this country amount to only a little more than what's necessary to cover private investment (as has long been the case), the government will have to borrow most of that $120 billion from foreign investors. But if foreigners are lending us a net $120 billion a year, that's $120 billion that foreigners are *not* spending to buy American products. That means we *must* run a corresponding trade deficit of $120 billion a year.

Prior to the 1980s, when government deficits were small, the U.S. overall trade situation was essentially in balance. Our net investment abroad was slightly positive from 1960 through 1981—the last year we ran a current account trade surplus. With the huge government budget deficits of the 1980s, however, came enormous trade deficits. If America is to return to being competitive in world trade, we must reduce our government's reliance on foreign lenders, which means we must cut the budget deficit. Anything else we do to try to make ourselves more competitive can have little if any positive effect (and if it adds to the budget deficit, will only make our trade problem worse).

### U.S. Trade Balance & the Government Budget Deficit
### 1960 to 1987 ($-billions)

| | Goods | | Services, etc.* | | Net Investment Income | | Balance on Current Account** | *Government Deficit (NIPA)**** |
|---|---|---|---|---|---|---|---|---|
| **1960-70** | $3.9 | + | −$5.7 | + | $5.0 | = | **$3.2** | ***−$2.6*** |
| **1971-81** | −14.5 | + | −4.0 | + | 18.8 | = | **0.2** | ***−17.7*** |
| **1982-83** | −51.8 | + | −2.5 | + | 26.8 | = | **−27.5****** | ***−119.7*** |
| **1984-87** | −134.9 | + | −15.9 | + | 22.0 | = | **−128.7** | ***−121.5*** |

**Includes earnings on direct investments, military, transportation, other services, etc.*

***Equals (with a minor discrepancy) net foreign investment. "−" means inflow of foreign funds.*

****Federal, state & local deficits, as measured in the national income and products accounts.*

*****In 1982 and 1983, lagging private business investment allowed the government's deficits to be financed largely out of domestic savings, but since business investment recovered, the government deficits have had to be financed almost entirely with money borrowed from foreign sources.*

### U.S. Gross Savings, Gross Investment & the Trade Balance
**As Shares of the Gross National Product**

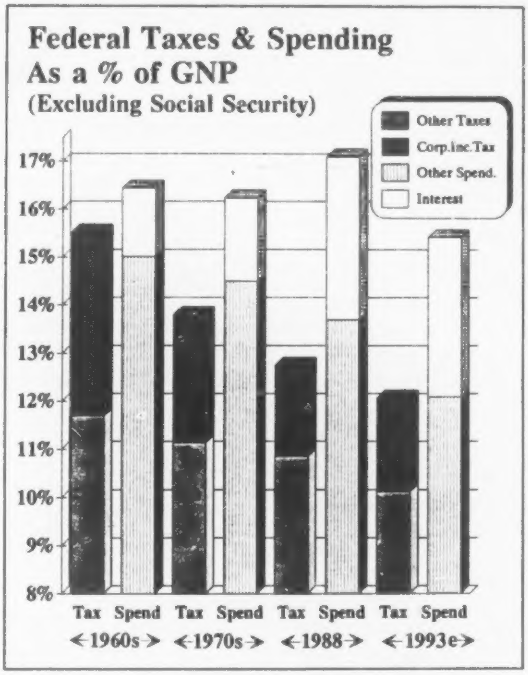
| | Private Savings | | Govern. Deficit | | National Savings | | Private Domestic Investment | | Saving minus Invest. | *Trade Balance (Curr. Acct.)* |
|---|---|---|---|---|---|---|---|---|---|---|
| **1960-73** | 16.7% | + | −0.4% | = | 16.3% | − | 15.7% | = | **0.6%** | ***+0.4%*** |
| **1974-81** | 17.9% | + | −1.2% | = | 16.8% | − | 16.6% | = | **0.2%** | ***+0.0%*** |
| **1982-88** | 16.5% | + | −3.0% | = | 13.5% | − | 15.7% | = | **−2.2%** | ***−2.4%*** |

## 4

## What Caused the Federal Budget Deficit?

It's a truism that, as a nation, we are failing to come close to paying for the full cost of our government. But is the source of this reckless behavior too much spending or too little taxes? Those who assert that excessive spending is the problem point out that since 1969 (the last year the budget was in balance) total federal spending rose from 19.8 percent of the gross national product to 22.3 percent in fiscal 1988—an increase of 2.5 percent of the GNP. Over the same period, total federal taxes fell by only 1.1 percent of the GNP—from 20.1 percent to 19 percent. Therefore, they argue, increased spending is the primary villain.

Spending critics often point to growth in "entitlements"—a code word for Social Security—as the main source of our deficit problem. But now that Congress has separated the fiscally solvent Social Security trust fund from the rest of the federal budget, it is clearer than ever that assertions about supposedly unrestrained federal spending are far off the mark. Indeed, to blame Social Security for the deficit problem is ludicrous. Certainly, Social Security benefits have risen over the years, but so have Social Security *taxes*. In fact, Social Security (OASDHI) now is running a huge budget surplus—amounting to just under 1.1 percent of the GNP in fiscal 1988, and expected to exceed 1.6 percent of the GNP in 1993.[3] Indeed, to an ever-increasing degree, we are using the regressive Social Security payroll tax to mask the full size of our deficit problem.



Putting aside Social Security shows a quite different picture:

- **Spending:** The cost of non-Social-Security federal programs as a share of the GNP is now *lower* than it was in the sixties, seventies or early eighties![4] Interest on the national debt, however, is up sharply.[5]
- **Taxes:** In contrast, non-Social-Security federal taxes have declined markedly as a share of the GNP—from 15.5 percent of the GNP in the sixties, to 13.8 percent in the seventies, to only 12.8 percent by 1988.
- **The Deficit:** Looking at non-Social-Security spending and taxes together makes the source of the deficit clear. Although the cost of non-Social-Security programs is down as a share of the GNP, non-Social-Security *taxes* are down even more. Of course, interest on the national debt also looms extremely large in the deficit picture. But the added federal interest outlays reflect increased debt due to previous deficits—deficits incurred primarily as a result of insufficient tax revenues in earlier years.

---

[3] Social Security spending grew from 2.7 percent of the GNP in the 1960s to 5.2 percent in fiscal 1988. Over the same period, Social Security taxes rose from 2.8 percent of the GNP to 6.3 percent. In fiscal 1993, Social Security spending is expected to total a bit under 4.6 percent of the GNP, while Social Security taxes are expected to be just under 6.2 percent of the GNP.

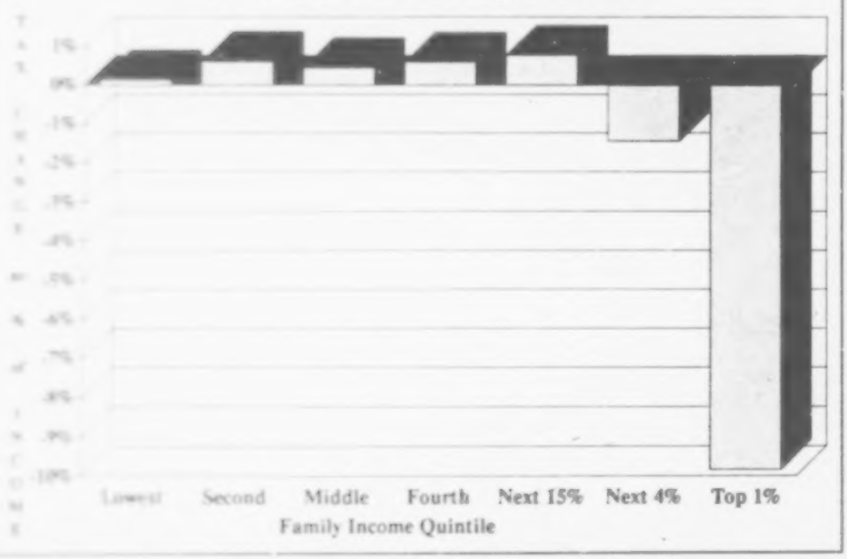
[4] From fiscal 1980 to fiscal 1988, defense spending grew from 5 percent of the GNP to 6.1 percent of the GNP. Over the same period, however, the cost of non-defense programs (excluding Social Security and interest) plummeted from 9.9 percent of the GNP to 7.5 percent of GNP.

[5] As the chart illustrates, federal interest payments grew from 1.4 percent of the GNP in the 1960s to 3.4 percent in fiscal 1988.

## The Alarming Growth in Inequality

To understand that insufficient revenues are at the heart of our deficit dilemma is an important first step in moving toward a solution to that problem. But it is equally important to recognize *whose* taxes we are talking about. Again, the data are very clear.

Study after study has concluded that despite all the rhetoric about so-called "across-the-board tax cuts," taxes have not been reduced for most Americans over the past decade. Perhaps the most comprehensive report on this topic was issued in October 1987 by the Congressional Budget Office. Examining the entire range of federal taxes, including personal and corporate income taxes, social security taxes and excise taxes, the CBO found that the vast majority of American families actually are paying a *higher* share of their incomes in overall federal taxes than they did ten years ago! Only the richest 5 percent of the population has enjoyed a reduction in taxes, with most of the tax cuts concentrated on the top one percent.[6] Indeed, the effective federal tax rate on the wealthiest one percent of the people has dropped by 10 percentage points since 1977. In 1988, that means an *average* tax cut for the super rich of $44,440 each—a 25 percent tax reduction since 1977.



Changes in Total Federal Taxes, 1977-1988
As a Percent of Family Incomes

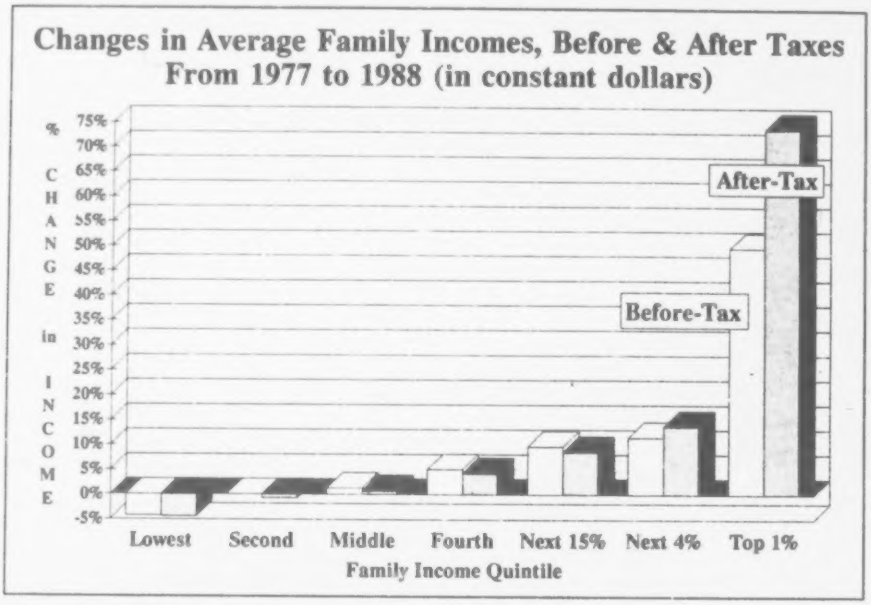
These regressive tax changes have coincided with and augmented an alarming shift in the distribution of pretax income in America—toward less equality. The CBO study reveals that, adjusted for inflation, real pretax earnings have stagnated or fallen for most segments of the population over the past 10 years, while the best-off people—most notably the richest 1 percent—have enjoyed huge increases in real income.

In 1977, the wealthiest one percent of the population took in 9.2 percent of total pretax income. By 1988, 12.5 percent of total income was concentrated on this elite group. The *average* pretax income of the richest one percent zoomed from $301,800 each in 1977 (in 1988 dollars) to $452,000 each in 1988—a 50 percent jump. Over the same period, the share of total income going to the bottom four-fifths of all families fell from 52 percent to only 48.2 percent.

---

[6] See Congressional Budget Office, *The Changing Distribution of Federal Taxes: 1975-1990* (October 1987). The figures reported here include CBO's imputation of corporate profits and corporate income taxes to owners of capital. The CBO report uses the Consumer Price Index to adjust incomes for inflation, while the information presented in this testimony uses the GNP deflator, which is probably a more accurate measure of inflation. If the CBO approach to inflation had been followed, the results would be even more striking.

**The after-tax shift in incomes:** The government's policy of cutting taxes on the rich even as their incomes have skyrocketed has made the shift in after-tax incomes particularly dramatic. For families in the first two income quintiles, real after-tax income has actually declined since 1977. The real after-tax earnings of families in the middle quintile grew by less than one percent over ten years. But the real after-tax income of the richest one percent of the population jumped by a staggering 74 percent!


Changes in Average Family Incomes, Before & After Taxes From 1977 to 1988 (in constant dollars)

**Making more and paying less:** The share of pretax income garnered by the top one percent of the population has increased enormously. But this group's share of the total federal tax burden has not come close to keeping pace. From 1977 to 1984, the share of federal taxes paid by the richest one percent *fell* by 8 percent. And despite tax reform, today the top one percent's share of total federal taxes is up by less than 3 percent compared to 1977, despite the 37 percent jump in their share of total pretax income.

The decline in taxes on the wealthy reflects not only reductions in personal income taxes, but also—in fact, primarily—the sharp drop in the corporate income tax, which fell from 3.8 percent of the GNP in the sixties, to 2.7 percent in the 1970s and to only 1.4 percent in the mid-1980s.[7] Even after the 1986 tax reform act, corporate income taxes—at about 2 percent of the GNP—remain well below their level in the sixties and seventies.

How can tax cuts for such a small proportion of our population loom so large in the deficit picture? It's simple arithmetic. The rich do, in fact, get a huge share of our nation's total income.

- This year, the richest one percent of the population will make $451 billion before taxes. That's more than the total income of the bottom 40 percent of all families.

- The almost $1.9 *trillion* in income concentrated on the top fifth of the nation's population—people making more than $50,000 a year—is greater than the total earnings of the remaining four-fifths of American families.

Thus a tax cut that amounts to 10 percent of income for the wealthiest one percent of the people adds up to $45 billion per year. Altogether, supply-side tax policies slashed federal taxes for the richest five million American families (including their share of the corporate tax reductions) by a total of almost $370 billion over the 1981-88 period. Thus, the total tax windfall for this wealthy group—so far—is more than double the current annual budget deficit.

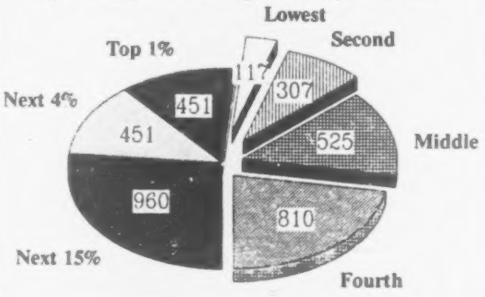
---

[7] The decline in corporate taxes reflects a drop in the effective corporate tax rate (taxes paid divided by pretax corporate profits, measured by the sum of taxes paid and taxes avoided due to loopholes, as reported by the congressional Joint Committee on Taxation) from 38 percent in the 1960s to 30 percent in the 1970s to less than 15 percent from 1981 to 1986.

Ironically, the policies that led to our current savings shortfall and consequent trade deficit were implemented in the name of encouraging and augmenting saving. Supply-side tax cuts enacted in 1978 and, especially, 1981 were touted as powerful incentives for increased private savings. Moreover, said proponents, the increased economic activity generated by the tax cuts would reduce government dissaving—and balance the federal budget in short order.

Of course, none of these predictions came true. On the contrary, private savings declined somewhat after the tax cuts were adopted, and, much more importantly, the government's deficits skyrocketed.

**The Distribution of Pretax Incomes, 1988**
**By Family Income Quintile ($-billions)**



## Personal Savings & Rates of Return

For years, economists have debated the effects of higher rates of return on the personal savings rate. Supply-siders have taken the unequivocal view that higher returns lead to more saving. They therefore favor tax breaks for interest, dividends, capital gains and so forth, on the theory that lower taxes on income from savings will spur more saving. Mainstream economists have accepted the supply-side view as potentially plausible for some people, but have pointed out a contradictory effect of higher rates of return. If a person is saving to meet a fixed goal—to buy a house, to fund a certain level of retirement income, etc.—then a higher rate of return, by allowing the person to reach the goal while saving *less*, may actually *discourage* savings. The mainstreamers note that economic theory cannot predict which effect will dominate.

The stability of the personal savings rate over long periods of time suggests that these two countervailing effects usually balance each other out. But in the 1980s, when very high rates of return (including low taxes) prevailed, it appears that the disincentive effect of higher rates of return was more powerful—leading to a lower rate of personal savings.

A clear example of what occured involves pension plans, in particular "defined benefit plans" that promise employees a certain amount after retirement. As rates of return on pension investments zoomed upward in the 1980s, especially due to capital gains in the stock market, companies found that they no longer had to put as much money into their employees' pension trusts in order to meet current and future benefit needs.

Indeed, many pension funds became so "overfunded" that companies terminated them, used part of the money to buy retirement annuities for their workers, and pocketed what remained after taxes.

As a result, in the 1980s, forced private retirement savings, a chief engine of savings for most Americans in the past, fell dramatically. Corporate contributions to pension plans dropped from 1.9 percent of the GNP in 1981 to only 1.2 percent in 1985—a decline of 34 percent. Factors such as the rising stock market and tax cuts seem to have affected other kinds of personal savings in a similar fashion. Total personal savings as a percent of the GNP fell by 34 percent over the 1981-85 period.*

It's important to note that the starting point for computing savings, gross national product, does *not* include speculative gains—or any capital gains for that matter. If the price of stocks or real estate doubles, for instance, GNP is not directly affected—since total output is not changed. Of course, the people (or pension funds or companies) who own that stock or real estate feel much richer—and, in fact, they are. But their good fortune doesn't mean that as a nation we have put more of our current output into real investments to meet future needs.

To the contrary, the beneficiaries of speculative gains are likely to spend part of their windfall on current consumption or to save less in the future. And when they do, the savings rate—the difference between output and consumption—falls.

Thus the lesson of the 1980s is that very high after-tax rates of return on savings will tend to depress the personal savings rate—an important factor for policymakers to take into account.

**Total private savings as a share of the GNP declined by only 5 percent from 1980 to 1985, because higher business savings offset most of the decline in personal savings. Since 1985, personal savings as a share of the GNP have remained about the same, but total private savings have declined an additional 9 percent. Overall national savings as a share of the GNP fell by 18 percent from 1980 to 1985, but were exactly the same in 1988 as in 1985, because of a decline in government deficits as a share of GNP over the three-year period.*

# What To Do

A decade and a half of tax policies designed to benefit corporations and wealthy people have come home to roost, creating federal budget deficits of an unprecedented scale. Currently, more than 25 percent of non-Social-Security federal spending is paid for by borrowing—up from just 5 percent in the 1960s. This huge federal demand for credit has led to increased real interest rates and enormous trade deficits, developments which threaten economic growth now and the standard of living of our children in the future.

This Committee will undoubtedly hear from the architects of the policies that have brought us to this sorry state. Some of them will say that nothing needs to be done, that we can continue to borrow and spend without a care for tomorrow. Others will recommend that the burden of deficit reduction should be borne by middle- and low-income families. To choose either of these approaches would violate basic fairness and economic common sense.

We know what lies at the heart of our deficit problem: insufficient revenues—more precisely, the sharp decline in both the corporate income tax and personal income taxes on the richest Americans. And when it comes to revenues, our options are stark. We can continue in the new spirit of fairness and reform reflected in the 1986 Tax Reform Act. Or we can reverse course and repudiate reform.

## Augmenting the Tax Shift; Repudiating Tax Reform

### Sales Taxes & Excise Taxes

Those who are now recommending big increases in federal excise taxes or adoption of a new European-style national sales tax argue that we need tax policies that will discourage consumption. Of course. That is the whole point of reducing the budget deficit—to shift our priorities more toward investment and less toward current spending. But virtually all tax increases, and many kinds of budget cuts for that matter, will have that effect. The real issue is: whose consumption should be reduced?

What we have learned from our experiment with supply-side incentives over the past decade and a half is that tax breaks supposedly designed to encourage private savings and investment have altogether perverse effects. While they caused dramatic and wasteful misallocations of investment and effort, they failed to lead to increases in aggregate savings or investment. Instead, they simply increased consumption opportunities for the well-off.

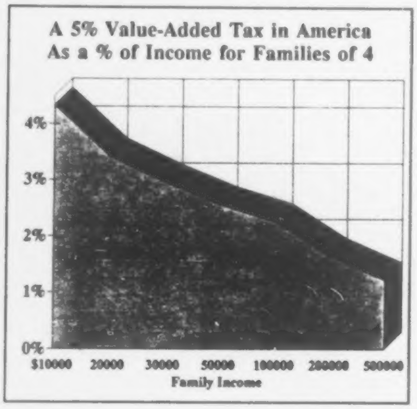
On the corporate side, for example, the huge array of new tax incentives adopted in 1981 failed miserably to lead to added business investment. Instead, the money went into increased dividends, sharply higher pay for executives and a wave of corporate mergers and acquisitions. And, conversely, when many of the so-called "incentives" were scaled back in the 1986 Tax Reform Act, the doomsayers who predicted a full-scale collapse in business capital spending were again proven wrong. Instead, business investment came back quite strong last year. As former Reagan Treasury official, J. Gregory Ballentine, told *Business Week*: "It's very difficult to find much relationship between tax rates and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]."

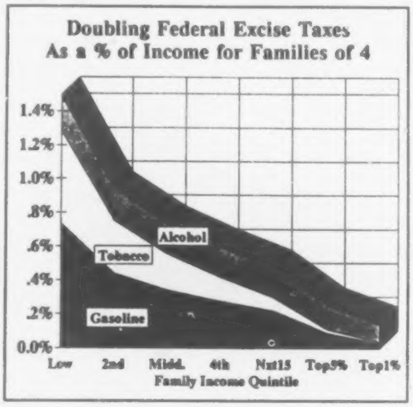
On the individual side, 1981's sharp reductions in tax rates on capital income, hugely expanded tax shelter opportunities and new "incentives" such as expanded eligibility for individual retirement accounts, did not produce the promised surge in personal savings. Instead, savings were merely shifted into tax-favored areas, while the beneficiaries of the tax breaks had more money to spend.

Thus, the question is not whether we want to curb consumption in favor of investment. We do. But do we want to make it a bit more difficult for wealthy people to buy their second Mercedes Benz, or do we want to put Plymouths and Chevrolets out of reach for many ordinary American families? Do we want to make it even harder for first-time homebuyers to achieve their dreams, or to we want to put a crimp in the style of people who buy 50,000-square-foot mansions? Those who push for sales and excise taxes want to curb spending by poor and middle-income families. Those who push for progressive tax changes want to curb consumption by the wealthy. When all is said and done, that is the choice that our nation faces.

Make no mistake about it, sales and excise taxes are inherently regressive. The chart below shows the distributional impact of a five-percent national sales tax, modeled after the value-added taxes in place in most European countries—which are roughly similar to the sales taxes in most American states. Even with the exemptions these countries provide for many food items, some clothing, health care and some medicines, and most housing, the poor would pay three times more of their income in added sales tax than the rich would. The tax would cost middle-income families almost twice as much of their earnings, proportionally, as the rich.

Federal excise taxes are, if anything, even more regressive than a national sales tax. The second chart shows the impact of doubling federal excise taxes on gasoline, tobacco and alcoholic beverages. As can be seen, the burdens as a share of income would be far higher on poor and middle-income families than they would be on wealthy people.


A 5% Value-Added Tax in America
As a % of Income for Families of 4


Doubling Federal Excise Taxes
As a % of Income for Families of 4

## Reversing the Tax Shift; Continuing in the Spirit of Reform
## Closing Income Tax Loopholes, Raising Tax Rates for the Wealthy

The 1986 tax reform act, in particular its corporate reforms, was an important first step toward reversing the tax shift of earlier years. The act took back a quarter of the tax cuts the richest five percent had received in earlier, tax-giveaway bills. And it used the money to roll back some of the previous tax increases that had hit most non-wealthy families, particularly the poor. But there is still a long way to go.

According to the Joint Committee on Taxation, the annual cost of corporate loopholes grew from $10 billion in 1970 to $120 billion by fiscal 1986, prior to tax reform. Many of the business tax breaks, of course, also translated into huge tax-shelter opportunities for the rich. Even after reform, business and investment tax breaks are expected to cost $212 billion in corporate taxes and $205 billion in personal income taxes from fiscal 1989 to fiscal 1993. Moreover, although the 1986 tax reform act significantly curbed upper-income tax shelters, the personal income tax reductions that those shelters previously provided the wealthy in essence were retained through the sharp cut in the top statutory income tax rate.

In approaching revenue options, we should keep in mind that, on the bottom line, every 1 percent levy on the incomes of the best-off 20 percent of Americans will add $19 billion to government revenues. In contrast, every 1 percent of income painfully extracted from the poorest fifth of all families adds only $1 billion a year to tax revenues. If the government is going to ask the American people to make sacrifices to reduce the deficit, it must go where the money is.

The focus of a fair tax-based deficit-reduction strategy should be to continue in the spirit of income tax reform, by closing unwarranted loopholes that remain in the law and by establishing tax rates sufficient both to pay for the cost of government and to stem the rise in inequality in our country.

Among the changes we need are: curbs on tax incentives for mergers and acquisitions; an overhaul of the system for taxing multinational corporations, to protect our tax base and our workers; depreciation reforms to bring the rules more in line with the way assets actually wear out; strengthening the corporate and individual Alternative Minimum Tax; further limits on expense account living; cutbacks in tax breaks for oil and timber companies; taxing capital gains on inherited property; and strengthening the "mansion cap" on mortgage interest deductions. We also need to correct the notorious backward bend in the personal tax rate schedule. Currently, when the income of a family of four exceeds about $94,000 ($71,900 in taxable income), the supposed top tax rate of 28 percent rises to 33 percent. But when income exceeds about $240,000, the rate drops back down to 28 percent again. Asking truly rich people and corporations to pay a higher rate than the near rich—say 38 percent—would raise more than $30 billion a year for the Treasury.

The kinds of proposals outlined here can raise whatever revenues we need to attack the deficit—without adding significantly to the burdens of ordinary American families. Indeed, almost all the added revenues would be obtained by reversing tax cuts previously granted to the wealthiest five percent of the people—those who can most afford to pay. At the same time, these changes would reduce economic distortions caused by current tax policies that sap productivity and long-term growth.

## Conclusion

The federal budget deficit *is* a real problem. Excessive government borrowing has soaked up funds that would otherwise have been available for private investment. It has made our nation increasingly dependent on foreign lenders, and is the root cause of our trade imbalance. It has sapped our ability to make the public investments—in education, infrastructure, science and R&D, for example—that we need to assure our future prosperity. And it severely constrains our government's ability to cope with future economic downturns.

Solutions to the deficit problem must flow from a proper understanding of its source.

The federal deficit does not come from too much spending—other than spending on interest on the debt. Sure, there are some programs that could be designed better or administered better. There are weapons systems that don't work the way they should and cost too much. These are serious issues. They should be addressed regardless of the size of the deficit. But they are not the root cause of the deficit. The answer lies elsewhere.

The federal deficit does not come from huge tax cuts for middle-class families and the poor. Far from it—as we have seen, ninety-five percent of American families are paying higher federal taxes today than they did a decade ago. These hard-pressed families, who by and large have watched their wages and incomes stagnate, are not the problem. The budget should not be balanced on their backs.

The federal deficit can be traced, in total, to huge tax breaks granted to the most wealthy American households over the past decade and a half. These households have watched their incomes and wealth grow by leaps and bounds, even as the nation that defends them, protects them and makes their way of life possible becomes poorer and more indebted by the minute. They are the folks to whom the bill should be sent.

The stakes are high: let us not sacrifice the standard of living of the vast majority of Americans and their children to underwrite the conspicuous consumption of the very rich.

Chairman ROSTENKOWSKI. What did you think of the 1981 tax cut, Mr. McIntyre.

Mr. McINTYRE. We were opposed to that on the theory it would devastate the economy and was very unfair.

Chairman ROSTENKOWSKI. There sure as heck were a lot of people in this chamber who were opposed to it. We tried right here in the Ways and Means Committee to do everything possible we could to curtail the Dole bill that came over from the Senate and of course, since 1981, all we have been doing is coming back to some normalcy in tax policy. At least in my opinion we have been trying to do that.

About VAT. Have any of you thought about the cost of the administration and when and if we did adopt such a program when we would start realizing the dollars that are necessary? The problem here is that we are going to need a fast turnover. We are going to need money quickly if we are going to try to solve at least even this slide-by budget that the President is talking about. We don't get that in a value-added tax.

But from some of the testimony that I have heard the expense of a value-added tax is tremendous administratively.

Mr. Christian?

Mr. CHRISTIAN. I don't claim to be an expert on that, Mr. Chairman. I will try not to overstate what I know. I believe that the idea that is brought up here, that the value-added tax is some complicated foreign mechanism that would be very difficult and expensive to put in place, is simply wrong.

Go back to the basics of what a VAT is. A VAT is a tax that is imposed at some rate of 10 or so percent on the output or the value added by a company or other business. The way they compute their increment of value added is to simply take their sales, the value of things they sold, services or goods, and subtract from that the inputs that they bought from other people. That is a very simple calculation.

Mr. McINTYRE. Mr. Chairman, we recently completed——

Chairman ROSTENKOWSKI. I am going to recognize Dr. Thorning because she was talking about a value-added tax, too. We will have you all participate in this discussion. We are going to have some fun this afternoon.

Ms. THORNING. I don't claim to be an expert on this issue either, but recently I was studying an article by an English professor of accounting who was comparing the administrative costs of a value-added tax to the corporate tax and to the personal income tax. He found that while the VAT was slightly more expensive to administer than the corporate income tax—remember England has an invoice credit value added tax, which requires the invoices to be kept track of, which is slightly more expensive for government officials to administer than the corporate income tax—it was no more expensive than the personal income tax, and also, the burden of taxpayers filing their returns was not substantially different. He did find it was a little more expensive for small companies—the VAT was—than for big companies.

Chairman ROSTENKOWSKI. I would like to hear from the Sears representative here with respect to implementing a value-added tax. With the complication of your system, how would you employ it?

Mr. SWANSTROM. The problems would be enormous. Business expenses would be very high. I don't have any particular estimates of costs to all business in the country. Of course, an old Treasury Department estimate is that it would cost $700 million for the Federal Government to implement or to turn the VAT per year and would take 20,000 employees. That is an old estimate. I am sure it has gone up. With inflation it probably would exceed a billion dollars.

Now, if the point of view of business is it is simply another burden and especially an enormous burden on small companies, the value-added tax would complicate matters. Before it was implemented it would cause consumers to go out and buy as much as they could. Of course, the estimates are it would take 18 months to implement a value-added tax. In the interim, people would be buying goods and then shut off their spending when the VAT did go on, which would cause what would probably be a fairly deep recession at that point.

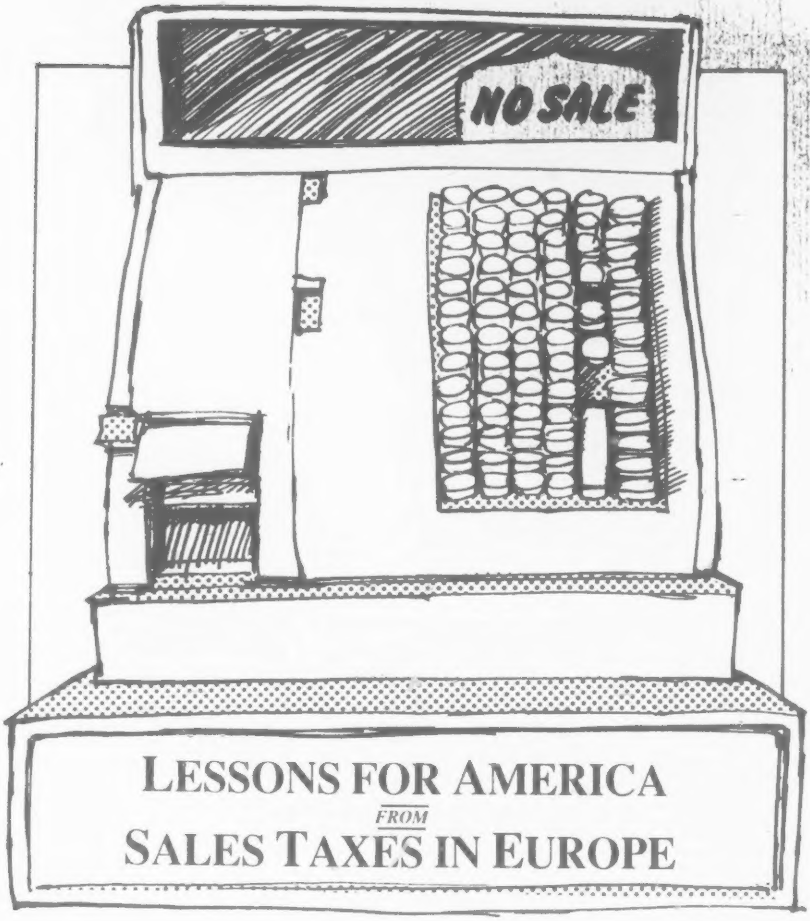
A value-added tax in itself, we assume, would be an add-on tax. We think it is unrealistic to consider that a value-added tax would be a partial or full replacement for the corporate income tax. If the value added tax is an add-on tax, it would be very inflationary for the economy and the prices though would include value-added tax, but it would be hidden from the consumer. Of course anytime it needed to be raised, it would be very easy then to generate more money for Congress. We think that this would put retailers, of course, in an especially bad light in terms of having to charge much higher prices to consumers for this value-added tax which would be unwarranted.

Chairman ROSTENKOWSKI. Mr. McIntyre.

Mr. MCINTYRE. I am surprised to say that I agree with Ms. Thorning. This doesn't happen that often but she is right. Administering a value-added tax would be as complicated, if not more complicated than administering the income tax. That means we would have to duplicate the IRS all over again.

We did a study on European VAT's and they are not the pristine thing that some economists talk about. They are full of the same kinds of normal exemptions, often good exemptions, that we have in the income tax. They don't tax food—or at least some kinds. They have special rules for rents and homes, and a variety of things. Maybe I can supply this study to the committee for the record.

[The study referred to follows:]



# LESSONS FOR AMERICA
*FROM*
# SALES TAXES IN EUROPE

**Citizens for Tax Justice**
Robert S. McIntyre
Director
David C. Wilhelm
Associate Director

*A joint project with the Institute on Taxation and Economic Policy*
*December 1988*

# NO SALE
## Lessons for America from Sales Taxes in Europe

IMAGINE, FOR A MOMENT, that you're the manager of a grocery store, somewhere deep in the heart of Italy. One of your responsibilities is to collect sales tax—or, as it's known in Italy, *Imposta sul Valore Aggiunto*—on the things that you sell. As it turns out, it's one of the toughest and most confusing parts of your job.

Italy's sales tax or more technically its "value-added tax," like similar "VATs" in other European countries, is the result of a complex web of economic, social and political judgments hammered out over many years. The sales taxes imposed on even a seemingly simple category of products like food reflect that complexity.[1]

Take seafood, for instance. The Italian government levies a 2 percent sales tax on seafood, unless it has already been prepared or preserved, in which case the VAT is 9 percent. Caviar, however, gets taxed at an 18 percent rate.

Now let's move over to the dairy case. Whole milk gets hit with a 2 percent rate, but skim milk is taxed at a 9 percent rate. Butter has a VAT of 2 percent, but cream is taxed at 9 percent. If you're the grocer, don't figure these wrong: your customers don't want to overpay; the government will get you if you don't collect enough.

Pasta, as one might suspect would be the case in Italy, gets taxed at the low rate of 2 percent. Vegetables are taxed at 2 percent if they're fresh and 9 percent if they're canned, unless the canned vegetable is peeled tomatoes, in which case the VAT falls back to 2 percent.

Meats are usually 9 percent items, although goose and duck pate are hit with an 18 percent rate.

It's enough to drive you to drink. If it does, the government seems to think that you should drink wine. Although excise taxes are applied to beer and spirits (in addition to the VAT), no excise tax at all is levied on wine.

Sounds crazy, doesn't it? But this is precisely the sort of tax system that some Washington, D.C. insiders would like to foist on America's businesses and consumers.

Supporters of an American national sales tax or value-added tax point to the European experience with VATs and suggest that we should learn from their example. Fair enough, we thought. So we took a long, hard look at VATs in Europe. The results of that long, hard look are reported here. We agree that there is quite a bit that can be learned from the European experience with VATs. They are lessons that should, once and for all, bring to an end any talk of bringing a VAT to our shores.

---

[1] Throughout this paper, the terms "sales tax" and "value-added tax" ("VAT") are used interchangeably. For a discussion of the essential equivalency of these taxes, see Appendix One.

# Who Pays Value-Added Taxes?

No one disputes the fact that a straight, unadorned value-added tax is regressive. A VAT, like any general sales tax, is a tax on consumption—and consumption as a share of income falls as income rises. Poor people have to spend all the money they have on the necessities of life. Middle-income people spend most of what they earn. But rich people have plenty of money left over after they've purchased all the goods and services they want. Thus, the value-added tax as a share of income falls sharply as income rises. That's what "regressive" is all about.

Not to worry, say proponents of an American VAT. It's possible, they assure us, to design a VAT that would not tax the poor unfairly and that, in fact, would be every bit as progressive as the personal income tax. We'll exempt the goods that are big ticket items in low-income budgets. We'll provide a rebate to the poor. We'll do whatever it takes. So they say. One of Washington, D.C.'s leading VAT proponents recently testified before the National Economic Commission that "economists agree that the VAT's regressivity can easily be fixed." He contended that "Western European nations have relied on either multiple rates (high rates on luxury items; lower rates on basic goods) or exemption of certain goods and services for that purpose."

What can we learn on this point from the European experience with VATs? Simply this: fairness and VATs have nothing to do with one another.

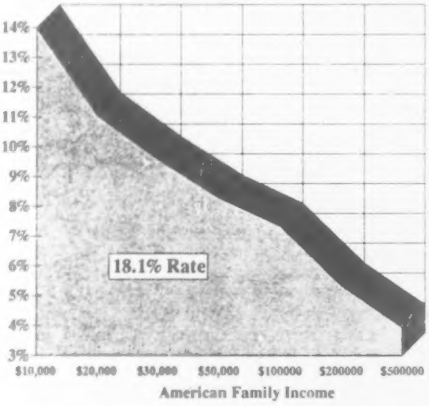
We asked the following question: who would bear the burden of the typical European-style VAT if it were applied here in the United States? What would it mean to American families if a VAT were applied in this country, using the same average rates on goods and services that are imposed in Europe?

The answer is not a comforting one for middle- and lower-income households:

- Families of four earning $10,000 a year would pay 14 percent of their meager incomes in added taxes.
- At $30,000 of income, the added tax burden would amount to almost 10 percent of family income.
- At $75,000 in earnings, the additional taxes would be more than 7 percent of income.
- But the richest people, making, say, $500,000 a year, would pay less than 4 percent of their income in added taxes.

**Value-Added Tax in Europe**

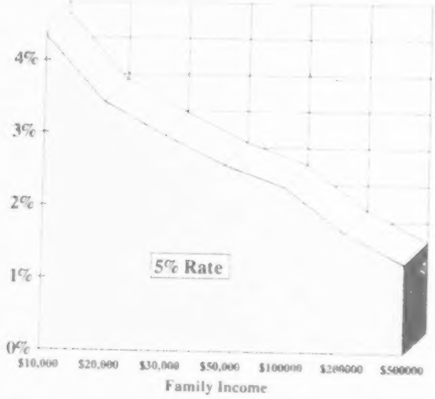
**As a % of Income for Families of Four**



The average "regular" VAT rate in the nine European countries we surveyed was 18.1 percent.[2] Proponents of an American VAT usually suggest a rate of somewhere between 5 and 10 percent for this country.

At a lower rate, an American VAT would be less onerous. But it would still be extremely regressive, piling up new burdens on those with the least ability to pay.

**A European-Style**
**Value-Added Tax at 5%**
**As a % of Income for Families of 4**



We calculated the impact on American families of a European-style VAT with a rate of 5 percent. The data are clear: even factoring in the typical exemptions or special rates provided in Europe, poor families would pay close to 4½ percent of their incomes in added taxes and middle-income families would pay about 3 percent. But rich people would pay only a bit over one percent of their incomes in additional taxes—a third the burden on the poor.

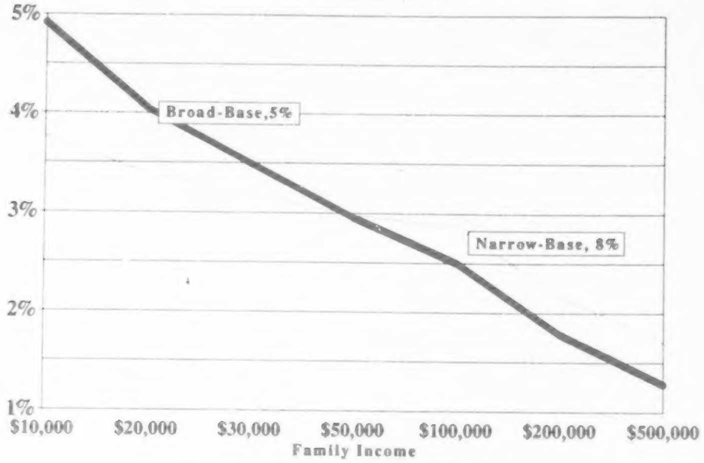
The evidence from Europe is compelling: a VAT is an unfair tax. Period. These are countries with long experiences with VATs and they have utterly failed to solve the regressivity problem. They have tried to alleviate it; most of these countries tax selected food products at special, usually lower rates, for instance. Indeed, the European VATs reflect a whole series of compromises: they are not as broad-based as some academic economists might wish, nor are they as narrow-based as the least regressive approach would require. But in every case, they are strikingly regressive. What reason do we have to believe that things would work out any differently here?

We really have no reason at all to believe that things would be different here. As the following graph indicates, even the most carefully chosen tax base for a national sales tax results in a very regressive tax. The two approaches illustrated below represent, on the one hand, the broadest conceivable sales tax base, with a rate of five percent, and, on the other, the base which—at an eight percent rate—raises the same amount of revenue and yields the fairest distribution of the tax burden. We should really say "the least unfair" distribution of the tax burden, because even this narrower tax base extracts a far greater share of the income of the poor—and of middle-income people—than of the well-to-do.

---

[2] For a list of the countries and their VAT rates on various items, see Appendices Two and Three.

**Broad & Narrow Base VATs**
**As a % of Income for Families of 4**



Promoters of a national sales tax have one final argument: we can devise, they say, a scheme of income tax rebates to offset the sales tax burden of the poor. But trying to turn an inherently regressive tax into even a proportional one is a Rube Goldberg scheme of the first order. None of the European countries we examined offers a VAT rebate plan for low-income families. Only six of the 45 American states with sales taxes have adopted rebate plans, and not a single one manages to cut the share of income paid in sales taxes by the poor to less than the share paid by the very rich. That matches up well with a 1984 Treasury Department study, which found that, in practice, even the most effective credit or rebate system imaginable would offset considerably less than half the sales tax burden paid by poor families. Among the administrative and logistical pitfalls, for starters, is the fact that most low-income families don't have to file federal income tax returns—which throws a pretty big monkey wrench into the rebate idea. Moreover, even if tax credits somehow succeeded in mitigating part of the sales tax load on the poor, they would be of little help to middle-income families, who would still pay far more of their income in added sales taxes than would the rich.

There is, it turns out, simply no way to design a VAT that yields anything close to even a flat distribution of the tax burden, let alone a progressive one. Even if the political will existed to do it, it still couldn't be done. It hasn't been done in Europe. And it can't be done here. If proponents of a VAT really supported fair taxes, they wouldn't be proposing a sales tax in the first place.

# What Gets Taxed?

Supporters of an American VAT have made a lot of promises to a lot of people. They promise that it would be simple to administer because it would tax a wide range of goods and services at a single low rate. They promise that it can be made fairer by raising the rate on some items and lowering the rate on others. They say to one group that the money it raises could be used to reduce the deficit, they say to another that it could fund the restoration of certain tax advantages to big business.

In short, they say things that are mutually exclusive. A VAT cannot be both easy to administer and filled with exemptions and preferences. It cannot be both broad-based and narrow-based at the same time. A VAT cannot be all things to all people.

Lobbyists for an American VAT can play this game because a VAT remains in this country a theory, an abstraction for economists to tinker with, something that has not yet been subjected to the realm of politics and Congress and dealmaking. Perhaps it's understandable that a theoretically perfect VAT can elicit some admiration from distributionally-indifferent academicians when it is contrasted to our admittedly imperfect income tax, which is the result of years of legislative tumult and political compromise.

But even if one is unconcerned or apathetic about equity, the proper basis of comparison is not that between an ideal, pristine VAT and the income tax of the workaday world. Rather, we must look at the VATs of the real world. The comparison should not be theory versus practice; it should be practice versus practice. And here, too, the lessons from Europe are very instructive.

In the following pages, we examine what gets taxed in Europe and at what rates. What emerges is something far different from the "macroeconomically neutral" VATs of economics textbooks. The European VATs are the products of a whole series of political compromises, replete with a wide array of exemptions and loopholes. They reflect, no doubt, the peculiar political relationships that exist in these countries, as well as the underlying cultural preferences that inform laws in any country.

There is no reason to believe that things would be any different here. Indeed, the institution of a VAT in the United States would be the ultimate full employment act for the legion of lobbyists that haunt the halls of Congress. Every single industry would seek favorable treatment for its products. Some would lose. But some would win. And we would wind up with a VAT that looks a lot like the ones we surveyed in Europe.

The following sections take a close look at how European countries treat various products, in particular, food and cars.

## Taxing Food in Europe:

Food purchases typically are given relatively favorable tax treatment under the value-added tax rules of European countries, just as they are under the sales tax laws of most American states. But the definitions of what kinds of food products are eligible for special treatment vary widely in different jurisdictions.

In the United States, state laws exempt about 77 percent of "food" purchases from sales taxes. But what constitutes "food" differs considerably from state to state. For instance, most but not all states tax carbonated beverages—nationwide, 85 percent of such purchases are taxable. Candy is taxed about two-thirds of the time. Alcoholic beverages are virtually always subject to sales taxes in addition to specific excise taxes, as is tobacco.

The practice in Europe is roughly similar. Many countries either exempt "food" or apply a lower than "normal" tax rate to it. But what is meant by "food" varies widely. In fact, the definitions of which items are eligible for special reduced (or sometimes increased) rates are usually extremely long and complex. Italy, for example, itemizes several hundred types of food and drink that are eligible for one or the other of its special rates. Often, the tax rates appear to reflect a country's particular politics rather than any coherent or systematic scheme. To illustrate:

1. The United Kingdom has a general exception from its 15 percent VAT for food. But there are numerous, often "very British" special rules:

- Candy and confectioneries are generally not eligible for the low rate—except for candied cherries and peels, which do enjoy the zero rate.
- Some beverages, such as milk, coffee, tea, cocoa and eggnog, enjoy the zero rate; others, such as fruit juices and carbonated beverages, are taxed at the 15 percent rate.
- Pastries with chocolate are taxed at 15 percent, except for cakes, which are exempt even if they have chocolate frosting.
- Certain snack-food items, including ice cream, sherbet, popsicles and potato chips, are subject to the 15 percent VAT, but most desserts enjoy the zero rate.
- Additional excise taxes apply to alcoholic beverages and tobacco.

2. In Italy, the VAT on food can be as little as 2 percent in some cases, 9 percent in others, and as high as 18 percent (the "regular" rate) for some items:

- Candy and chewing gum generally are taxed at the 9 percent rate, except for "fancy" chocolates, which are subject to the 18 percent rate.
- Most fruits are taxed at 2 percent (although there is a special added excise tax on bananas). But fruits that are frozen or preserved with added sugar are subject to the 9 percent rate.
- Beverages such as coffee and tea are taxed at 9 percent (plus a separate excise tax). Table wine and beer enjoy the 9 percent rate, too (although beer is hit with an added excise tax). But carbonated beverages are taxed at 18 percent.
- Fresh seafood is generally taxed at 2 percent, but prepared or preserved seafood is subject to the 9 percent rate, and caviar is taxed at 18 percent.
- Meats are usually 9 percent items, except for goose and duck pate, which are taxed at 18 percent.
- Butter, margarine, cheese and fresh, whole, unsweetened milk are taxed at 2 percent, but cream, yogurt and sweetened, concentrated, powdered or skim milk are taxed at 9 percent.

- Pasta, bread, vegetable oil, olives, fresh vegetables and canned, peeled tomatoes all enjoy the 2 percent rate. But fish and animal oils, cereals, cakes, soups, sauces, sweet potatoes and most canned vegetables are taxed at 9 percent.
- If an Italian makes salad dressing, the oil is subject to a 2 percent VAT, but the vinegar is taxed at 9 percent.
- Besides bananas, additional Italian excise taxes apply to sugar (and, thus, products containing sugar), vegetable oil, margarine, honey, coffee, cocoa, beer and spirits (but not wine) and tobacco.

3. In the Netherlands, food is generally taxed at 6 percent, instead of the regular 20 percent VAT rate. But numerous food items are not eligible for that low rate. Fruit juices, carbonated beverages, candy and chewing gum, for instance, don't qualify. Lobsters, oysters, caviar, smoked salmon, and duck and goose pate also are taxed at the 20 percent rate. So are popsicles, potato chips, sherbet (as opposed to ice cream) and certain other, often finely defined items.[3] Added excise taxes apply to sugar (and thus in part to products with sugar added), alcoholic beverages and tobacco.

4. Belgium taxes most food items at a reduced rate of 6 percent, instead of the regular VAT rate of 20 percent. But added excise taxes apply to items such as candy, carbonated beverages, fruit juices, fruits frozen or preserved with sugar added, desserts, jams and jellies, fine pastries, alcoholic beverages and tobacco. Margarine is taxed at the full 20 percent rate. And lobsters, oysters and caviar are taxed at a special high rate of 25 percent.

5. In France, the regular VAT rate is 18.6 percent. Food is most often taxed at only 5½ percent, but a variety of rates for different items are on the books. For example,

---

[3] The fine distinctions among food items in the Netherlands are illustrated by the following extract from the source materials:

> The Official Explanation to table I . . . should be consulted as it clarifies the meaning of the specified products and services.
>
> For example, in item No. A.1., the reduced rate of tax applies only to fresh potatoes harvested by cultivators, and if necessary, made ready for sale to the public. It includes potato seeds for bedding out (planting), steamed and peeled potatoes (fresh), and canned potatoes. However, the Explanation specifies that the reduced rate of tax does not apply to products such as chips (patates frites or French fries), dried potatoes, and potato mash.
>
> Another example of a case where the Explanation must be consulted is with respect to item No. B. 12. The products listed in Appendix I-A and served in an establishment such as a restaurant, hotel, boarding-house, or similar place, are subject to the reduced rate of tax, even if the products are not served on the spot but, are, instead, either delivered or brought to the home. Products not listed in Appendix I-A are subject to the normal rate of tax. For example, automatic food shops, butcher's shops, etc., are not establishments similar to a restaurant, hotel, etc., and thus products, such as cheese and sauté, listed in Appendix I-A and bought for consumption on the spot, are subject to the normal rate of tax. On the other hand, catered food in the form of a complete meal is subject to the reduced rate of tax to the extent the products involved are listed in Appendix I-A and/or if such meal is served in a restaurant or the like. It is stipulated in the Explanation, however, that ice cream is, according to general living standards, deemed to be a component of a complete served meal, while sherbet is not, and as such is subject to the normal rate of tax.
>
> The products mentioned in Appendix I-A are only subject to the reduced rate of tax if they are served at a restaurant, boarding-house, hotel, etc. to guests who stay there for a short period of time. With respect to persons who permanently live in hotels, boarding-houses, etc., the normal rate of tax will be applied for their complete meals served on the spot for consumption even if the products are mentioned in Appendix I-A.

carbonated beverages, candy, margarine, fruit juices, eggnog, mineral water and cocoa are taxed at the regular 18.6 percent rate, while coffee and tea enjoy the 5½ percent rate. Certain luxury foods, such as caviar, are taxed at a special increased rate of 33.3 percent. Added excise taxes apply to mineral water, animal and vegetable oils, tobacco and sugar beets.

6. Germany taxes most food items at 7 percent, half its regular VAT rate of 14 percent. But there are a number of exceptions:

- Candy enjoys the 7 percent rate, but fruit juices and carbonated beverages are taxed at 14 percent.
- Coffee, tea and mineral water are taxed at 7 percent; cocoa and eggnog, at 14 percent.
- Most seafood enjoys the 7 percent rate; but lobsters, oysters and caviar are taxed at 14 percent.
- Meats are typically taxed at 7 percent, except for snails, which are taxed at the full 14 percent rate.
- Additional excise taxes apply to sugar and sugar substitutes (and, thus, in part to sweetened foods), coffee, tea, salt, beer, brandy, champagne and tobacco.

7. Luxembourg knocks its regular VAT rate down to 6 percent for most food items, and to only 3 percent for some things.

- The 3 percent category applies to meats, poultry, butter, unsweetened milk and cream, lard, bread and rolls.
- Cheese and sweetened milk and cream are taxed at 6 percent, while ice cream and yogurt are taxed at 12 percent.
- Candy, carbonated beverages, eggnog and cocoa are taxed at 12 percent; coffee, tea and mineral water, at 6 percent.
- Products with sugar added, such as pastries, cakes and some frozen fruits are subject to an additional excise tax, as are alcoholic beverages and tobacco.
- Ice cream, potato chips, peanut butter, sherbet, preserved meals, syrups and saccharin are all taxed at the full 12 percent rate.

8. Sweden and Denmark have no exceptions for food. It is subject to the regular 23.46 percent VAT in Sweden and to the 22 percent ~~VAT in~~ Denmark, just like other items. Denmark, however, applies additional excise taxes to sugar (and, thus, in part to products containing sugar), as well as to beer, wine, spirits and tobacco. Sweden imposes additional excise taxes on candy, mineral water, beer and tobacco.

## Taxing Automobiles in Europe:

In the case of automobiles, most American states with sales taxes apply the full sales tax rate to car purchases. In Europe, the common practice is to tax cars, as well as motorcycles, at *higher* rates than the normal ones. Of the nine European countries examined in this report, only Denmark and Germany impose the same rate on cars and motorcycles that they generally apply to other items.

- In Italy, cars with engines larger than 2,000 cubic centimeters and motorcycles with engines larger than 350 cc are taxed at 38 percent, instead of the regular 18 percent VAT rate.
- In Belgium, the tax rate on cars and motorcycles is 25 percent, instead of the regular 20 percent VAT rate. Mopeds, however, are taxed at the regular rate, and cars for disabled or handicapped persons are taxed at a special low rate of 6 percent.
- In the Netherlands, the tax rate on cars depends on both the price and how much pollution a car produces. Low-pollution automobiles priced at less than $5,000 are taxed at the regular 20 percent rate. High-pollution, low-price cars are taxed at 37 percent. A low-pollution car costing $20,000 is taxed at 38 percent. And a high-pollution car costing $20,000 is taxed at 45 percent. Motorcycles and mopeds costing less than $3,000 are taxed at 28 percent; a $6,000 motorcycle is taxed at 32 percent.
- France taxes cars, as well as motorcycles with engines larger than 240 cc, at 33.3 percent. The regular 18.6 percent rate applies to smaller motorcycles, mopeds and cars for the handicapped. An added excise tax also applies to cars.
- In the United Kingdom, cars are subject to a 10 percent wholesale tax in addition to the 15 percent VAT. That brings the total sales tax on automobiles to about 23 percent.
- Sweden and Luxembourg impose additional excise taxes on purchases of cars and motorcycles.

## Taxing Business Use of Cars and Meals & Entertainment Expenses in Europe:

Far from being simple, the rules governing sales taxes—both in the United States and in Europe—are extremely complex. Typically, the laws provide for hundreds of special exceptions and rates, and exceptions to the exceptions as well. But determining what categories of spending ought to be taxed is not the only source of complexity in a sales tax.

For example, personal use of "company cars" and tax breaks for business meals and entertainment are usually considered to be income tax issues. But the same questions inevitably arise under a value-added tax. Most European countries do not allow businesses a tax credit for the VAT they pay on these items (as Appendix One explains, they normally do for business purchases to avoid double taxation), because they are considered to constitute personal consumption by the business people.

In fact, of the nine countries examined, only Germany and Luxembourg allow a full VAT credit for business cars, meals and entertainment.

**Business Automobiles:**

- In the United Kingdom, France, Denmark, Sweden and Italy, no VAT credit is allowed for business automobiles. (Italy makes an exception for salesmen. Sweden allows a half credit for the cost of leasing automobiles.)
- Belgium allows only a half VAT credit for cars that are used for both business and personal purposes.

- The Dutch allow a full VAT credit for business purchases of cars, but impose a 2½ percent annual tax on the purchase price of business automobiles as an offset to the VAT credit.

**Business Meals and Entertainment:**

- In Belgium, the United Kingdom, France and Denmark, no VAT credit is allowed for business meals and entertainment. (Belgium does allow a credit to salesmen; the U.K. allows a credit if a foreigner is being entertained.) Denmark disallows the VAT credit for hotel expenses as well.
- The Netherlands allows a VAT credit for meals and entertainment only for expenses of $250 a year or less.
- Italy allows a VAT credit for entertainment expenses, but not for meals and drinks.
- In Sweden, no VAT credit is allowed for wine and alcohol expenses that are not deductible under the income tax.

## Taxing Other Goods & Services in Europe

Widely differing treatments of food and cars are only the beginning. When it comes to VAT, most European countries have numerous other things that they like and things that they don't. For instance:

- Belgium seems to have a bias against mechanical gadgets. Home appliances, such as refrigerators and washing machines, lawn mowing equipment and other yard machinery, clocks, electric blankets, watches, hair dryers, televisions, video toys and cameras, among other things, are all taxed at a special high rate of 25 percent instead of the usual 20 percent.

  The Belgians favor cleanliness, however, at least if it's accomplished through non-mechanical means. Cleaning products, detergents, soaps and toothpaste are all taxed a special *low* rate of just 6 percent.

- The French, contrary to their reputation, show a marked antipathy toward luxury items and pornography. Furs, expensive jewelry, "fancy" televisions and stereos, cameras, film and admission to pornographic movies and plays all are taxed at 33.33 percent, rather than the regular rate of 18.6 percent.
- Italy shares France's bias against luxury goods. Oriental rugs (from the middle east), furs and "luxury" televisions, stereos, video equipment and cameras are taxed at rates ranging from 34 percent to 38 percent. Even "non-luxury" photo gear is taxed at 26 percent. But "non-luxury" soap and some kinds of clothing get a break from the regular 18 percent rate; they are taxed at just 9 percent.
- The Germans show a touch of culture, taxing admissions to movies, concerts and plays at half the regular 14 percent rate (while admissions to sporting events are taxed at the full regular rate). For some mysterious reason, Germany imposes a special added excise tax on light bulbs.
- In contrast to Germany, Luxembourg favors sporting events over movies. The former are taxed at only half the regular 12 percent rate; the latter, at the full regular rate.

- In the Netherlands, favoritism goes to circuses and zoos. Admission to them is taxed at only 6 percent, while admissions to movies, concerts, plays and sporting events are taxed at the full 20 percent rate.
- In Sweden, admissions to movies, concerts, plays and sporting events are supposedly tax-exempt. But it isn't necessarily that great a deal. They're a funny kind of "exempt" that really means they're partially taxed (see Appendix One).
- The United Kingdom shows some concern for young folks. Children's clothing and shoes are generally exempt from tax; clothing for their parents is taxed at the full 15 percent rate. Whether small adults can sneak by as kids is unclear.

## Administering Sales Tax Exemptions

With so many fine distinctions among fully taxable, partially taxable and exempt items, the result is a far cry from the promise of administrative simplicity that is so often a part of the pitch of VAT proponents in this country.

Retailers almost inevitably make mistakes on whether something should be taxed or not. And with stiff penalties for not collecting sales taxes that are supposed to be due, the errors typically aren't in consumers' favor.

The box on this page illustrates the problems that retailers in the District of Columbia have in deciding if particular products qualify for the District's sales-tax exemption for medicines. A survey of D.C. stores found them charging sales tax on supposedly exempt items almost half the time. Even stores with computerized cash registers had the problem—since the computers are only as accurate as their programmers.

### Sales Tax Exemptions in the District of Columbia

*Roberta Baskin of Washington, D.C.'s Channel 7 News looked at how the District of Columbia's sales tax exemption for medicines works. On January 7, 1986, she reported her findings.*

*Baskin and her staff went shopping for supposedly exempt items at various D.C. stores, spending about $75. "In our simple random survey," she found, "we were overcharged nearly 50% of the time" [on exempt items].*

**Roberta Baskin:** "You are *not* supposed to be charged the 6% sales tax on any product used in the prevention or cure of disease or illness."

**Joe Lund, Tax Administrator in the District:** "This leaves it up to the seller to determine whether they have those items in them. And that becomes a bit of a question of whether it does have something in it that will keep it from being taxed."

**Roberta Baskin:** "The answer seems to be: when in doubt, tax it. . . . Here's how the guessing game works. Chapstick is taxable. Blistex is not. (It has a medicated ingredient.) We were taxed on both. . . .
"When we asked [D.C.] tax experts if rubbing alcohol was taxable or not, the District didn't know, and said they'd have to check with a pharmacist. Target 7 checked six pharmacists. Three did not charge sales tax. Three did."

**Joe Lund:** "For the businesses with computers in their cash registers, there isn't such a problem because they code the items."

**Roberta Baskin:** "But they're not necessarily coded *correctly*. Take a common everyday purchase: fluoride toothpaste."

**Joe Lund:** "Fluoride has been one of those items that has been considered a medicine or pharmaceutical. So when you find it in a product, that product should not be taxable."

**Roberta Baskin:** "But wherever we shopped, we were charged an illegal tax on fluoride products. The computer cash registers are *programmed* to charge tax on fluoride at the major chains in town. . . .
"Everywhere we went, we found errors—*never* in our favor."

Similar problems exist under European value-added taxes—at every stage of production and sale. Indeed, there can be special added difficulties because of the way a VAT is structured. Producers and merchants are supposed to be granted refunds of the value-added taxes they pay on items that enable them to make or sell their products. (See Appendix One.) But what about businesses that deal primarily or totally in tax-exempt or low-tax products? How are rebates to be granted if they add up to more than the value-added taxes these businesses collect from their customers? The practice in Turkey, explained in the box on this page, may seem like a caricature of proper tax administration. But alternatives that might be applied in the United States, such as trying to use the corporate and individual income tax system to provide rebates, would inescapably be fraught with their own complexity and administrative problems.

## Value-Added Tax in Turkey: A Vignette

*"Basic foodstuffs are subject to zero-rate and repayments of input tax may be claimed. The excess tax charged will be refunded upon application to the local tax office."* Katma Deger Vergisi Kanunu, *Turkish VAT Law No. 3065, as amended.*

One day in the Spring of 1986, the internal revenue minister of the Republic of Turkey paid a call on us at Citizens for Tax Justice. The minister was eager not only to learn about American tax policy, but also to tell us about Turkish tax practices.

For example, he explained how in his country, because certain terrorist organizations harass the remote and underdeveloped areas near the Iranian border, there is not enough industrial development underway. To turn this around, Turkey's central government gives virtually permanent tax holidays to almost any kind of business that can survive a year in that zone.

### Turkish food rules

The standard rate of VAT on taxable transactions is 10%. However, the Council of Ministers is authorized:
(1) to increase the rate to 15%; reduce it to 5%; or fix a rate in between for various goods and services;
(2) to reduce the rate to "0" or raise it back to the normal rate on supplies of basic foodstuffs.

The zero rate is applied to the following list of basic foodstuff supplies:
(1) Animals for butchery, poultry, fish and their meat (excluding their products).
(2) Lentils, broad-beans, chick peas, dried beans (excluding their products).
(3) Barley, corn, soybean, bran, oat and rye.
(4) Eggs.
(5) Milk, yogurt, feta cheese (excluding other dairy products).
(6) Wheat, wheat flour, bread, bulgur, semolina, macaroni, rice in the husk and rice.
(7) Sugarbeet, sugar (in powder or cubes).
(8) Vegetable margarine and oil for human consumption, butter, and raw oil used in the production of olive oil, sunflower oil, cotton-seed oil and cooking oil.
(9) Animal feed (used in producing meat, milk, fish, eggs and honey) and fish flour, meat and bone flour, blood flour.

The 1% rate is imposed on the following supplies: dried hazel-nuts, vetch, pistachio (unprocessed), licorice plant root, licorice extract, bay leaf, thyme, sumac leaf, arbor vitae, mahaleb, soapwort.

The following goods are subject to supplementary tax . . . when imported or delivered by their producers:
(a) Tobacco products 50%
(b) All kinds of alcoholic drinks (including natural sparkling wine, vermouth and quinquina wine, excluding other wines and beer) 30%
(c) Other wines and beer 15%
(d) all kinds of non-alcoholic drinks (excluding "gazoz"—a kind of sweetened and carbonated soft drink—and fruit juices) 10%
Note: the supplementary tax rates for groups (a) and (b) are raised to 100% for domestic deliveries and reduced to 0% at importation by a governmental decree.

Perhaps harsh conditions might justify for Turkey the clumsy incentives that we were working to abolish in the U.S., I allowed. But how, given the general tax forbearance on Turkish business as a whole, did his country hope to pay for the roads, schools and other basic services that undergird development?

With our national sales tax, he said, beaming. With the VAT.

Through the translator, he outlined how the VAT works in Turkey. It is a complex system of varying levies on almost every imaginable item produced by agriculture or industry. On its face, the tax is extremely unfair. But American VAT scholars had informed the Turkish government that exempting certain items, such as food, could mitigate the inequities of the VAT—albeit with resulting economic distortions that the experts decried.

The Turks had taken this advice to heart. But, my guest noted, merely sparing consumer food purchases from tax would not do the trick. VAT paid by farmers and food merchants must be refunded. If not, VAT still would be built into food prices. How are farmers and store owners to obtain their refunds? Simple: a national network of "rebate houses."

"Do you mean," I asked, "that farmers and food sellers send to the government for tax rebates?"

Not exactly "send," he said. More like "go."

Go? I fancifully envisioned long lines of small-business men and women waiting outside the doors of tax houses, whiling away hours while taking care not to lose any of hundreds of pieces of paper clutched in calloused hands. But I quickly dismissed the thought: why would a developing country that gives tax breaks for industrial development order its entrepreneurs to waste time standing around? Surely a capital-starved industrializing country should encourage laboring, not queuing.

But it is true. In Turkey, business people seeking refunds of the VAT must travel to the rebate houses, of which there are about eight hundred scattered across the country. Carrying their receipts, they wait in line at the village tax center. At the head of the line, the official in charge checks the receipts against a list of items on which taxes may be rebated.

"It is very fair," the commissioner said. "It is very rare for anyone to have to wait for more than a few hours. Never more than a day."

"Ah," said I. "Not only fair, but efficient."

"Precisely," he said.

*—Bruce Fisher*

# Setting Up a VAT

Contrary to the claims of some VAT proponents, a VAT would not be a simple (or cheap) thing to set up and administer from the government's perspective—or from the point of view of businesses either. If enacted, it would be a new tax, needing a whole new set of rules, forms and bureaucrats to collect the money that it raised. Businesses would have to hire a new army of lawyers and accountants specializing in VAT to tell them how much to pay. Universities, law schools and business schools would need new teachers and new departments to instruct the specialists in the intricacies of how to comply with—or avoid—the new tax.

Again, the international experience with VATs is illuminating. According to Alan Tait of the International Monetary Fund, countries with VATs have found administrative costs to be high—about two percent of VAT revenue.[4] A 1978 study of the costs of collecting VAT in Great Britain found compliance costs to be 78 percent of tax liability for small retailers![5]

A study published by the Treasury Department in 1984 concluded that 20,000 civil servants would be needed to administer a VAT if one were introduced in the United States—a ratio of one bureaucrat for every thousand taxpayers.

If the objective of a revenue increase is to deal with our deficit problems quickly, a VAT is the wrong way to go about it. With anything as new, untested and complicated as an American VAT, there inevitably would be a considerable gestation time between conception and delivery. Henry J. Aaron, an economist with the Brookings Institution puts it this way:

> A VAT is likely to take 12 to 18 months longer to implement than an increase in income taxes. Even if a new president decides to propose a value-added tax, he is unlikely to do so before late 1989 or early 1990. In the unlikely event that Congress speedily agrees, it would take the Internal Revenue Service 18 months to 2 years to hire and train new administrators, design rules and forms, and carry out the public education necessary before revenues could actually be collected. No revenues from a VAT could be expected before 1992 and, quite possibly, 1993.

In other words, by the time the first dollar from a VAT could be collected, the next presidential campaign will have been long under way—and perhaps already completed. A VAT simply does not provide our nation with the flexibility it needs to cope with our mounting fiscal and trade deficits—problems we need to face now, not four or five years from now.

---

[4] By contrast, the Internal Revenue Service's entire budget for processing tax returns, examination and appeals, investigation, collection and taxpayer services, salaries and other expenses amounted to only about one-half of one percent of total federal tax revenues in fiscal 1988.

[5] *See* Godwin, *Compliance Costs of VAT to the Independent Local Retailer*, The Structure and Reform of Direct Taxation: Report of a Committee Chaired by Professor J.E. Meade (J. Meade ed. 1978), p. 489, cited in James S. Henry, "Noncomplicance with U.S. Tax Law—Evidence on Size, Growth, and Composition," *The Tax Lawyer* (Fall 1983), p. 21.

# Economic Effects of a National Sales Tax

WHY WOULD WE WANT TO IMPOSE AN UNFAIR NEW TAX that soaks the poor and spares the rich? Why would we want to sock it to the needy so soon after the recent federal tax reforms, whose crowning achievement was to roll back the Reagan-era tax increases on low-income families? Why would we want to add a new layer of huge complexity and paperwork onto the shoulders of American businesses and onto an Internal Revenue Service that has trouble enforcing the current system? According to sales tax proponents, we need a new tax on spending in order to curb consumption and boost national savings.

To be sure, America does need to increase its savings rate—or more precisely, we need to curb our government's borrowing rate. Federal deficits have soaked up private savings that would otherwise be available for business investment, and have caused the government to skimp severely on the public investments we need for the future. They've made us increasingly dependent on foreign lenders. If we are to save more as a nation, we need to spend less. That's a truism.

But we face a delicate balancing act. Business investment, except where it is distorted by tax policies, is linked to expectation of profit, which in turn depends on product demand. That's the whole theory of a free market economy. Thus, for starters, deficit reduction needs to be carefully coordinated with monetary policy to avoid making the cure worse than the disease. Without reduced interest rates from the Federal Reserve Board as part of the package, cuts in the budget deficit could easily lead to both reduced consumption *and* reduced investment. If VAT proponents are correct that a national sales tax would stifle consumer demand more than other deficit reduction approaches, then it would be a particularly dangerous strategy to adopt.

There is little or no evidence, however, that sales taxes result in lower consumption or higher savings in the aggregate compared to other types of taxes. In fact, virtually all tax increases, and many kinds of budget cuts for that matter, will have the effect of shifting our priorities toward more investment and less toward current spending. The real issue is: whose consumption should be reduced?

The claim is often made that European value-added taxes result in a higher private saving rate in Europe. But the facts contradict this assertion. The two nations in the world with the highest personal savings rates, Italy and Japan, rely the least on consumption taxes to finance their governments. (Japan, like the United States, has no national sales tax, although it may soon adopt a very small one.)

American experience with sales taxes at the state level offers a useful lesson in this regard. If sales taxes really are such a potent device to foster savings, why isn't our national savings rate already booming as a result of the sales taxes imposed by the states? Not only is there not a shred of evidence that state sales taxes have augmented personal savings nationwide, there also is no indication that people who live in states with high sales taxes save more than their counterparts in states with low sales taxes. Anyone who expects to find that Delaware residents save less than Texans because Texas relies heavily on sales and excise taxes, while Delaware does not, will be disappointed.

Many of the same people who now are pushing for a national sales tax made the same kinds of claims on behalf of tax "incentives" for savings and investment in the past. They are the ones who were most opposed to loophole-closing provisions of the 1986 Tax Reform Act. That's not surprising; tax breaks for saving and tax penalties on consumption are flip sides of the same coin. But what we have learned from our experiment with supply-side loopholes over the past decade and a half is that tax breaks supposedly designed to encourage private savings and investment have altogether perverse effects. While they caused dramatic and wasteful misallocations of investment and effort, they failed to lead to increases in aggregate savings or investment. Instead, they simply increased consumption opportunities for the well-off.

On the corporate side, for example, the huge array of new tax incentives adopted in 1981 failed miserably to lead to added business investment. Instead, the money went into increased dividends, sharply higher pay for executives and a wave of corporate mergers and acquisitions. And, conversely, when many of the so-called "incentives" were scaled back in the 1986 Tax Reform Act, the doomsayers who predicted a full-scale collapse in business capital spending were again proven wrong. Instead, business investment has come back extremely strong this year. As former Reagan Treasury official, J. Gregory Ballentine, told *Business Week*: "It's very difficult to find much relationship between tax rates and investment. In 1981 manufacturing had its largest tax cut ever and immediately went down the tubes. In 1986 they had their largest tax increase and went gangbusters [on investment]."

On the individual side, 1981's sharp reductions in tax rates on capital income, hugely expanded tax shelter opportunities and new "incentives" such as expanded eligibility for individual retirement accounts, did not produce the promised surge in personal savings. Instead, savings were merely shifted into tax-favored areas, while the beneficiaries of the tax breaks had more money to spend.[6]

### The Spurious Trade Argument

**An ancillary claim made by some sales tax proponents is that an American value-added tax would improve the U.S. trade balance. At first glance, their argument may be beguiling. Since the value-added tax would be collected only on goods entering the United States, not on those leaving, they say, the result would be to encourage exports and penalize imports.**

**There is nothing wrong with this reasoning—except that it is totally illogical. Foreign goods imported into the United States would indeed be subject to a U.S. national sales tax, but so would U.S. products sold in the United States. Similarly, U.S. exports would be exempt from a U.S. sales tax, but so would be foreign goods they compete with abroad.**

**By way of analogy, does anyone think that Connecticut businesses enjoy a competitive advantage over New Hampshire ones because Connecticut has a steep sales tax while New Hampshire has none? Of course not.**

**Charging a federal sales tax on imported Toyotas would not make Chevrolets more attractive to American consumers because the same tax would apply to sales of Chevrolets. And rebating the U.S. sales tax on exported Chevrolets would not make them more saleable in Japan, since Chevrolets would still be subject to the same Japanese taxes that Toyotas are. The argument that a VAT would be good for trade simply doesn't hold water.**

---

[6] Some people may have saved more in response to the increased rate of return that putting money into an IRA offered. But others found that higher after-tax returns meant that they could save less and still reach their retirement income goals. As it turned out, virtually all the money that flooded into IRAs —mainly from upper-income people—was simply transferred from other kinds of savings. The overall personal savings rate actually declined after IRA eligibility was expanded.

Thus, the argument that future tax increases need to spare the rich is refuted by our sad experience with trickle-down ideology over the past decade. Since 1977, federal taxes on the richest one percent of Americans have been slashed by 25 percent. Yet personal saving, if anything, has declined rather than increased. Does repeating the discredited policies of the past make any sense?

To repeat, the question is not whether we want to curb consumption in favor of investment. We do. But do we want to make it a bit more difficult for wealthy people to buy their second Mercedes Benz, or do we want to put Plymouths and Chevrolets out of reach for many ordinary American families? Do we want to make it even harder for first-time homebuyers to achieve their dreams, or to we want to put a crimp in the style of people who buy 50,000-square-foot mansions? Those who push for sales and excise taxes want to curb spending by poor and middle-income families. Those who push for progressive tax changes want to curb consumption by the wealthy. When all is said and done, that is the choice that our nation faces.

## How Efficient a Revenue Raiser?

ONE OF THE MOST CYNICAL ARGUMENTS made by VAT proponents is that their tax has political appeal. Because it can be hidden in the price of products, they say, average citizens may not realize that they are paying the tax. And those who are smart enough to recognize the impact of the tax will go along as well, they imply, because the tax largely exempts the most politically powerful segments of our society,

Indeed, many people who support deficit reduction only if it means reduced federal spending on social programs or public investment are particularly opposed to a national sales tax because they accept the argument of VAT proponents that the tax would be a largely hidden "money machine" for the government.

The real world evidence is not so clear cut, however. On the one hand, the United States and Japan, two countries with no national sales tax, also provide the lowest levels of government services to their citizens, as shares of their national incomes. On the other hand, among European countries there is little correlation between reliance on sales taxes and the level of government spending.

Here in the United States, many state officials think that sales taxes are the most efficient way to raise money for state government. But this notion doesn't withstand analysis. When the ten states with the highest sales and excise taxes on low-income families are compared to states that rely more on progressive income taxes, a pattern emerges: the states that take it out of the hides of the needy are less equipped to deliver basic public services.

In the ten American states with the highest sales and excise taxes on the poor —an average of 7.7 percent of their meager incomes—revenues available to pay for public services amount to 10.3 percent of total personal income. By contrast, in the ten states with the lowest sales and excise taxes on the poor—an average of 3.5 percent of their earnings—funds available to pay for public services amount to 11.8 percent of total personal income.

A recent Congressional Budget Office report shows that the best-off fifth of the population—people making more than $50,000 a year—makes more than the remaining four-fifths all put together. The richest one percent alone makes more each year than the poorest 40 percent of all families. In terms of taxes, every one percent of income paid in taxes by the best-off fifth of the nation's population amounts to $19 billion. It would take a tax of 16 percent on the income of the poorest fifth of the people to raise the same revenues.

The point here is more arithmetical than political: taxing the poor heavily is both cruel and inefficient. It doesn't produce much in the way of revenues because the poor don't make very much money.

## Conclusion

THERE ARE A NUMBER OF THINGS that we and those who support an American VAT agree on. We believe that deficits matter, and that the current policy of borrow and spend is both irresponsible and immoral. We believe that the growing mountain of debt threatens our nation's standard of living and our standing in the world. And we believe that our nation's consumption must be curtailed and our national savings rate must be boosted.

The key question that our nation's lawmakers must address is: whose taxes should go up or whose government services should be scaled back to generate the needed reduction in the deficit? Or looked at more basically, whose consumption should be curtailed?

Those who support an American VAT have a very clear answer to this question. They know full well that a VAT is regressive. It takes a much larger chunk out of the pockets of middle-income families and the poor than from the well-to-do. Anyone who argues that countries in Europe have figured out ways to make their VATs fair is either severely misinformed or prevaricating.

Supporters of a VAT want to reduce the deficit on the backs of hard-pressed middle-income families, working people and the poor. It's that simple. VAT proponents are willing to put up with all the new complexity, all the new political conflict, all the inevitable new economic distortions, as well as a four or five year delay in dealing with the deficit, in order to assure that the burden of deficit reduction is imposed on ordinary people—on the very people who have watched their incomes stagnate and their federal taxes climb in recent years.. It's their taxes that would be raised to end the "dissaving" by the federal government. It's their consumption that would be further curtailed.

American businesses that sell goods and services to people in the middle to lower ends of the income distribution should think very carefully about this fact. A VAT would leave less money in the hands of average American consumers. They would have less money at their disposal with which to buy food, cars, beverages and other household items. Indeed, a 10 percent VAT would add $1,200 to the price of a

$12,000 car—no doubt a principal reason why General Motors is dead set against such a tax. Sure, a VAT is "good for business"—if you sell to the wealthy. But it's bad news if your principal customers are the non-rich.

The past few years have been extraordinarily good ones for the conspicuous consumption of the well-to-do. Just take a look at the growth in sales of BMWs, Mercedes, furs, high-priced jewelry and multi-million dollar houses. For families with incomes in excess of $200,000 a year, the past decade has brought a growth in real incomes of 50 percent and a decline in federal taxes of 25 percent. Meanwhile, for 95 percent of American families—all but the best-off 5 percent—overall federal taxes take a higher share of income than they did ten years ago. Do we really want to make things even tougher on average families? Why not begin with those who have enjoyed the spending binge of the 1980s?

Why not indeed? After all the waste, fraud and abuse in government programs that can be stopped has been stopped, we inevitably will need added revenues if we are serious about deficit reduction. The federal income tax—both corporate and individual—is where we should look. Additional revenues should be elicited from wealthy individuals and corporations that, even after tax reform, still fail to pay their fair share. In other words, those who can best afford it should have their consumption curtailed in order to stop the dissavings by our federal government.

By closing unwarranted income tax loopholes, by instituting a tax bracket of 38 percent on incomes in excess of $240,000, the United States can raise tens of billions of dollars in additional revenues a year. We can curb excessive consumption, reduce the deficit and strengthen our economy without squeezing further already hard-pressed middle- and low-income families. We can, in short, address the budget deficit responsibly, without sacrificing the standard of living of this generation and the generations to come.

The stakes are high. And the lessons from Europe about sales taxes are clear. We need to move forward and build on the spirit of equity and economic common sense that underlay the 1986 Tax Reform Act, not reverse course and impose a complicated and unfair new tax on American consumers and American businesses.

# Appendix One: The VAT Mechanism

In final result, a value-added tax and a sales tax are essentially identical. When a consumer buys a taxable product or service, he or she pays the tax. If a product costs $150 and the sales tax or value-added tax rate is 10 percent, the tax will be $15, and the consumer will pay it at the time of purchase.

To be sure, in the case of a VAT there *are* a number of intervening steps in the tax process. But in the aggregate, these steps cancel each other out.

For instance, take a simple case in which a product has four stages of production and sale. First, a manufacturer buys raw materials and makes the product. Then, the product is sold to a wholesaler, then to a retailer, and finally to the customer. At each stage, the seller will collect the value-added tax, and get a rebate for taxes previously paid in the process. To illustrate:

| **Selling event:** | **Price** | **10% Tax** | **Rebate** | **Net tax** |
|---|---|---|---|---|
| Raw materials to manuf. | $ 30 | $ 3 | — | $ 3 |
| Product to wholesaler | $ 70 | $ 7 | $ (3) | $ 4 |
| Product to retailer | $ 90 | $ 9 | $ (7) | $ 2 |
| Product to customer | $150 | **$15** | $ (9) | $ 6 |
| **Total tax collected:** | | **$34** | **$(19)** | **$15** |

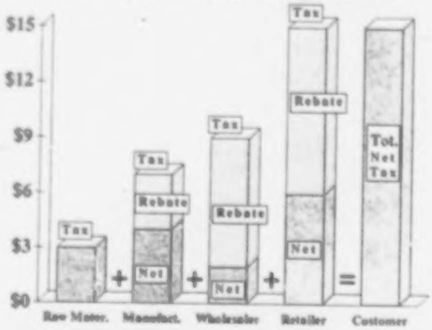
**Effective rate of tax: $15/$150 = 10%**

Thus, in this example, the retailer collects $15 in value-added tax from the customer when the product is sold—just as with a sales tax. That $15 is paid to the government—again just like a sales tax. In addition, however,

- the retailer files for a $9 tax rebate from the government;
- the wholesaler pays $9 in VAT and files for a $7 rebate;
- the manufacturer pays $7 in VAT and gets a $3 rebate; and
- the raw-materials suppliers pay $3 in VAT.

Since it all adds up to the same thing, why go through all this complicated paper work? In Europe, the rationale was not merely to create jobs for accountants and lawyers (although it certainly has had that result). Other reasons include:

**A 10% VAT in Operation On a $150 Final Purchase**

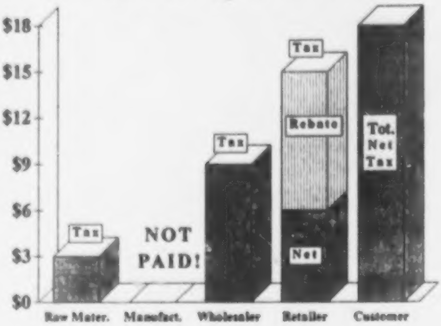


- In most European countries, stage-by-stage transaction taxes were already in place when VATs were adopted, so that businesses already were familiar with a similarly complex tax mechanism.
- Some political cynics argue that a VAT generates less political resistance than a sales tax, because it is easier to "hide" the tax in the price of products under a VAT than with a retail sales tax. It's worth noting, however, that in many European coun-

tries, VAT is itemized on consumer purchases, just as state sales taxes are in the United States.

- The VAT's multi-stage collection process may serve to mitigate tax evasion problems. If one company in the chain fails to pay the tax, then presumably it won't file for a rebate of taxes paid and passed on by its suppliers. The result is that, except for tax evasion at the retail level, failure to pay the VAT can actually *increase* the total tax collected by the government on a product! This point can be illustrated with a variation on the previous example:

**A 10% VAT on $150**
**With a Break in the Chain**



| **Selling event:** | **Price** | **10% Tax** | **Rebate** | **Net tax** |
|---|---|---|---|---|
| Raw materials to manuf. | $ 30 | $ 3 | — | $ 3 |
| Product to wholesaler | $ 70 | not paid! | — | — |
| Product to retailer | $ 90 | $ 9 | — | $ 9 |
| Product to customer | $150 | $15 | $ (9) | $ 6 |
| **Total tax collected:** | | **$27** | **$ (9)** | **$18!** |

**Effective rate of tax: $18/$150 = 12%!**

- Politically-required exemptions for certain products and services can be structured to make supposedly "exempt" items partially taxable in reality. This is called an "exemption without credit for previously paid tax." (On the other hand, it's also possible to have *real* exemptions, by applying a "zero-rate" at the retail level—*with* a credit for previously paid taxes.)

✓ Here's an illustration of how an "exemption without credit" isn't a true exemption from tax:

| **Selling event:** | **Price** | **10% Tax** | **Rebate** | **Net tax** |
|---|---|---|---|---|
| Raw materials to manuf. | $ 30 | $ 3 | — | $ 3 |
| Product to wholesaler | $ 70 | $ 7 | $ (3) | $ 4 |
| Product to retailer | $ 90 | $ 9 | $ (7) | $ 2 |
| Product to customer | $150 | "exempt" | — | — |
| **Total tax collected:** | | **$19** | **$(10)** | **$ 9** |

**Effective rate of tax: $9/$150 = 6%**

✓ In contrast, here's how a "zero rate" at the retail level, *with* a credit for previously paid taxes, *is* a true exemption from value-added tax:

| **Selling event:** | **Price** | **10% Tax** | **Rebate** | **Net tax** |
|---|---|---|---|---|
| Raw materials to manuf. | $ 30 | $ 3 | — | $ 3 |
| Product to wholesaler | $ 70 | $ 7 | $ (3) | $ 4 |
| Product to retailer | $ 90 | $ 9 | $ (7) | $ 2 |
| Product to customer | $150 | exempt | $ (9) | $(9) |
| **Total tax collected:** | | **$19** | **$(19)** | **$ 0** |

**Effective rate of tax = 0%**

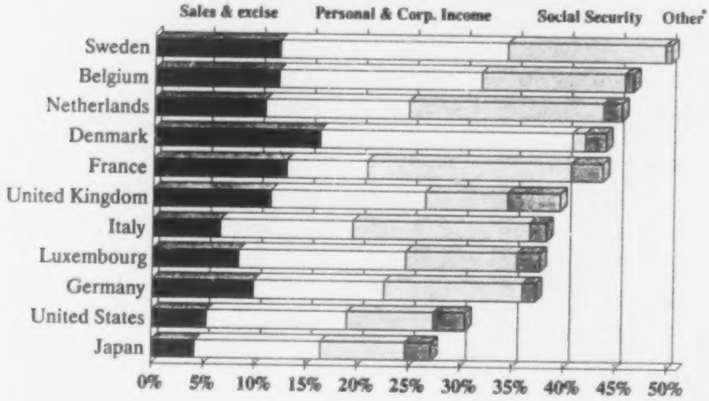
# Appendix Two
# The Countries Surveyed

In attempting to outline some of the multitudinous problems that a federal sales tax would create in this country, we have undertaken a detailed analysis of national sales taxes, or value-added taxes, as they exist today in nine European countries.

Overall taxes in these countries range from as high as 50.3 percent of gross domestic product in Sweden to as low as 37.3 percent in Germany—in all cases considerably more than in the United States (or in Japan). Sales and excise taxes, primarily value-added taxes, range from as high as 16.2 percent of GDP in Denmark, to as low as 6.6 percent in Italy—again considerably higher than in the United States or Japan.

Although sales and excise taxes are not the single largest source of government revenues in any of the countries analyzed, they do play a significant role in all of them, as the following chart illustrates:

## Taxes as a Percent of GDP In 11 Countries in 1982



*Primarily property, estate & gift taxes.

Source: U.S. Treasury Department

# Appendix Three: A Summary of VAT Rates In Nine European Countries

| **Belgium** | **Rates** | **Notable Applications** |
|---|---|---|
| Adopted: 1971 | 20% | Normal rate |
| Replaced: Cascade tax | 0% | Some newspapers, magazines published weekly or more often |
| | 4.4% | Life insurance |
| | 6% | Clothing material, shoe repair, most foods, beer, coal, transit, rents to tourists, drugs, funerals, admissions, books, some newspapers and magazines |
| | 9.15% | Medical and car insurance |
| | 12.5% | Used buildings |
| | 17% | Laundry and dry cleaning, shoes, meals away, new buildings, electricity, heating oil, natural gas, wallpaper, carpets, artworks and antiques |
| | 25% | Cars, gasoline, motorcycles, motor oil, somewhat fancy jewelry, leather clothing, cheap watches, caviar, lobsters, oysters, spirits, wine, clocks, artificial and dried flowers, tools, appliances, yard machinery, ornaments, thermometers, barometers, hair care appliances, personal care services, film purchases and development, photo equipment, ammunition, televisions, stereos, tires |
| | 33% | Furs (except rabbit), very fancy jewelry, expensive watches, guns |

| **Denmark** | **Rates** | **Notable Applications** |
|---|---|---|
| Adopted: 1967 | 22% | Normal rate |
| Replaced: Wholesale tax | 0% | Newspapers |
| | Exempt w/o Credit | Education, rents, medical services, insurance, funerals, banking, some transit |

| **France** | **Rates** | **Notable Applications** |
|---|---|---|
| Adopted: 1955, 1968 | 18.6% | Normal rate |
| Replaced: Cascade tax | 2.1% | Newspapers |
| | 4% | Magazines |
| | 5.5% | Some foods |
| | 7% | Medicines, some admissions, some meals away, some hotels, some rents, most books, public transit |
| | 33.3% | Cars, some motorcycles, luxury items (e.g., perfume, caviar, furs, expensive jewelry, photo equipment, some television sets) |
| | Exempt w/o Credit | Education, medical services, used home sales, artworks |

| **Germany** | **Rates** | **Notable Applications** |
|---|---|---|
| Adopted: 1968 | 14% | Normal rate |
| Replaced: Cascade tax | 7% | Some foods, books, newspapers, magazines, some admissions, local transit |
|  | Exempt w/o Credit | Education, rents, financial, medical services, home sales (but added excise tax applies) |

| **Italy** | **Rates** | **Notable Applications** |
|---|---|---|
| Adopted: 1971 | 18% | Normal rate |
| Replaced: Cascade tax | 0% | Salt, newspapers, some telephone |
|  | 2% | Some food, some drugs, some rents, new homes, magazines, maps |
|  | 9% | Some clothing, some food, charcoal, electricity, natural gas, some hotels, non-luxury soap, some drugs, admissions |
|  | 26% | Non-luxury televisions, stereos, etc. |
|  | 34% | Luxury televisions, stereos, etc. |
|  | Exempt w/o Credit | Education, banking, medical services, insurance, funerals, local transit |

| **Luxembourg** | **Rates** | **Notable Applications** |
|---|---|---|
| Adopted: 1970 | 12% | Normal rate |
| Replaced: Cascade tax | 3% | Some food, prescription drugs |
|  | 6% | Some food, beer, electricity, natural gas, non-prescription drugs, funerals, accounting fees, legal fees, books, magazines, newspapers |
|  | Exempt w/o Credit | Education, rents, home sales, banking, insurance, medical services, admissions, transit |

| **Netherlands** | **Rates** | **Notable Applications** |
|---|---|---|
| Adopted: 1969 | 20% | Normal rate |
| Replaced: Cascade tax | 6% | Clothing and shoe repair, some food, some meals away, home sales (used) yard machinery, soaps, prescription drugs, some legal fees, books, magazines, newspapers, transit, admissions to circuses, etc. |
|  | 28%+ | Motorcycles |
|  | 37%+ | Some cars |
|  | Exempt w/o Credit | Education, telephone, rents, medical services, insurance, banking, funerals |

| **Sweden** | **Rates** | **Notable Applications** |
|---|---|---|
| Adopted: 1969 | 23.46% | Normal rate |
| Replaced: Retail sales tax | 0% | Fuels, electricity, prescription drugs |
| | 3.95% | Certain construction |
| | 12.87% | Meals away, hotels, some rents |
| | Exempt w/o Credit | Education, home sales, telephone, medical services, funerals, legal fees, insurance, personal care services, admissions, lessons, some transit |

| **United Kingdom** | **Rates** | **Notable Applications** |
|---|---|---|
| Adopted: 1973 | 15% | Normal rate |
| Replaced: Purchase tax | 0% | Children's clothing, some food, education, heating fuels, electricity, prescription drugs, new home sales, magazines, newspapers, some transit |
| | 23% | Cars (including wholesale tax) |
| | Exempt w/o Credit | Rents, medical services, funerals, some financial services |

| **United States (Broad Base)** | **Rates** | **Notable Applications** |
|---|---|---|
| *Adopted: ????* | *???* | *Normal rate* |
| *Replaced: ????* | *0%* | *Education, hospitals, local public transit* |
| | *Exempt w/o Credit* | *Rents, medical services, banking, taxis, insurance* |

*NOTES: Exempt without credit means no tax at the retail level, but taxes at earlier stages still apply. See Appendix One.*

*The description of a possible broad-base VAT in the United States is taken from U.S. Department of the Treasury,* Tax Reform for Fairness, Simplicity, and Economic Growth, Volume 3, Value-Added Tax *(Nov. 1984). While suggesting that such a broad base would be the preferable approach, that report recommended against adoption of a VAT in the United States.*

## VAT: A Focus on Food

| | Sweden | Den. | Italy | Germ. | Belg. | Neth. | France | Lux. | U.K. |
|---|---|---|---|---|---|---|---|---|---|
| **Regular VAT rate:** | 23.46% | 22% | 18% | 14% | 20% | 20% | 18.6% | 12% | 15% |
| **Regular VAT rate on food:** | 23.46% | 22% | 2-9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| **Vegetables:** | | | | | | | | | |
| Vegetables: fresh, frozen or cooked (generally) | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Vegetables: high starch, e.g. sw. potatoes | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Vegetables: preserved, ground, pulverized | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Tomatoes—peeled and preserved | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Olives preserved in brine | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Sugar beets | 23.46% | 22% | 9% | 7% | 6% | 6% | *5.5% | 6% | 0% |
| **Fruits and nuts:** | | | | | | | | | |
| Fruit: fresh,dried,preserved,frozen—w/o sugar | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Bananas | 23.46% | 22% | *2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Fruits: frozen or preserved with sugar | 23.46% | *22% | *9% | *7% | *6% | *6% | 5.5% | *6% | 0% |
| Nuts: unsalted & unroasted | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Nuts: roasted in shell | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Nuts: salted or roasted w/o shell | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 15% |
| **Dairy products, eggs:** | | | | | | | | | |
| Milk: fresh, unsweetened | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 3% | 0% |
| Milk: fresh, sweetened | 23.46% | *22% | *9% | *7% | *6% | *6% | 5.5% | *6% | 0% |
| Milk: concentrated, unsweetened | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 3% | 0% |
| Milk: concentrated, sweetened | 23.46% | *22% | *9% | *7% | *6% | *6% | 5.5% | *6% | 0% |
| Milk: powdered, unsweetened | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 3% | 0% |
| Milk: powdered, sweetened | 23.46% | *22% | *9% | *7% | *6% | *6% | 5.5% | *6% | 0% |
| Milk: skim | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 3% | 0% |
| Butter | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 3% | 0% |
| Cheese | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Cream: unsweetened | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 3% | 0% |
| Cream: sweetened | 23.46% | *22% | *9% | *7% | *6% | *6% | 5.5% | *6% | 0% |
| Yogurt: unsweetened | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Yogurt: sweetened | 23.46% | *22% | *9% | *7% | *6% | *6% | 5.5% | *12% | 0% |
| Yogurt: frozen | 23.46% | *22% | *9% | *7% | *6% | *6% | 5.5% | *12% | 15% |
| Ice cream | 23.46% | *22% | *18% | *7% | *6% | *6% | 5.5% | *12% | 15% |
| Eggs | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| **Meat, poultry:** | | | | | | | | | |
| Meats: unprocessed,preserved,cooked (uncanned) | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 3% | 0% |
| Meats: cooked and canned | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Poultry and products, except pate | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Pate of goose or duck liver (uncanned) | 23.46% | 22% | 18% | 7% | 6% | 20% | 5.5% | 3% | 0% |
| Pate of goose or duck liver (canned) | 23.46% | 22% | 18% | 7% | 6% | 20% | 5.5% | 6% | 0% |
| Snails | 23.46% | 22% | 9% | 14% | 6% | 6% | 5.5% | 6% | 0% |
| **Seafood:** | | | | | | | | | |
| Fish: fresh | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Crustaceans, exc. lobsters: fresh | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Mollusks except oysters: fresh | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Lobsters: fresh | 23.46% | 22% | 2% | 14% | 25% | 20% | 5.5% | 6% | 0% |
| Oysters: fresh | 23.46% | 22% | 2% | 14% | 25% | 20% | 5.5% | 6% | 0% |
| Fish preparations except caviar, etc. | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Caviar | 23.46% | 22% | 18% | 14% | 25% | 20% | 33.3% | 6% | 0% |
| Smoked salmon | 23.46% | 22% | 9% | 7% | 6% | 20% | 5.5% | 6% | 0% |
| Crustaceans, exc. lobsters: prep./preserv. | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Mollusks except oysters: prep./preserv. | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Lobsters: prepared/preserved | 23.46% | 22% | 9% | 14% | 25% | 20% | 5.5% | 6% | 0% |
| Oysters: prepared/preserved | 23.46% | 22% | 9% | 14% | 25% | 20% | 5.5% | 6% | 0% |
| **Processed foods:** | | | | | | | | | |
| Flour | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Bran | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Oils, vegetable | 23.46% | 22% | *2% | 7% | 6% | 6% | *5.5% | 6% | 0% |
| Oils, animal & fish | 23.46% | 22% | 9% | 7% | 6% | 6% | *5.5% | 6% | 0% |

| **Food, continued:**<br>**Country:** | **Sweden** | **Den.** | **Italy** | **Germ.** | **Belg.** | **Neth.** | **France** | **Lux.** | **U.K.** |
|---|---|---|---|---|---|---|---|---|---|
| Vinegar | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Lard | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 3% | 0% |
| Margarine | 23.46% | 22% | •2% | 7% | 20% | 6% | 18.6% | 6% | 0% |
| Bread & rolls | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 3% | 0% |
| Ginger bread | 23.46% | •22% | •9% | •7% | •6% | •6% | 5.5% | •12% | 0% |
| Pastries (fine bakers' wares) | 23.46% | •22% | •9% | •7% | •6% | •6% | 5.5% | •12% | ↓↓ |
| Pastries without chocolate; cakes | ↑↑ | ↑↑ | ↑↑ | ↑↑ | ↑↑ | ↑↑ | ↑↑ | ↑↑ | 0% |
| Pastries with chocolate (not cakes) | ↑↑ | ↑↑ | ↑↑ | ↑↑ | ↑↑ | ↑↑ | ↑↑ | ↑↑ | 15% |
| Cereals | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Pasta | 23.46% | 22% | 2% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Sauces | 23.46% | 22% | 9% | 7% | 6% | 20% | 5.5% | 6% | 0% |
| Soups | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Peanut butter | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 12% | 0% |
| Jams and jellies | 23.46% | •22% | •9% | •7% | •6% | •6% | 5.5% | •6% | 0% |
| Honey | 23.46% | 22% | •9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Syrups | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 12% | 0% |
| Apple sauce | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 6% | 0% |
| Popsicles, etc. | 23.46% | •22% | •9% | •7% | •6% | •20% | 5.5% | •12% | 15% |
| Potato chips, etc. | 23.46% | 22% | 9% | 7% | 6% | 20% | 5.5% | 12% | 15% |
| Instant breakfasts | 23.46% | •22% | •9% | •7% | •6% | •6% | 5.5% | •12% | 0% |
| Preserved & ready meals | 23.46% | 22% | 9% | 7% | 6% | 6% | 5.5% | 12% | 0% |
| Pudding powder | 23.46% | •22% | •9% | •7% | •6% | •6% | 5.5% | •12% | 0% |
| Desserts | 23.46% | •22% | •9% | •7% | •6% | •6% | 5.5% | •12% | varies |
| Sherbet | 23.46% | •22% | •9% | •7% | •6% | •20% | 5.5% | •12% | 15% |
| **Sugar and spices:** | | | | | | | | | |
| Salt | 23.46% | 22% | 0% | •7% | 6% | 20% | 5.5% | 6% | 0% |
| Spices | 23.46% | 22% | 9% | 7% | 6% | 20% | 5.5% | 6% | 0% |
| Sugar | 23.46% | •22% | •9% | •7% | •6% | •20% | 5.5% | •6% | 0% |
| Saccharin | 23.46% | 22% | 18% | •7% | 6% | 20% | 5.5% | 12% | 0% |
| **Candy, etc.:** | | | | | | | | | |
| Candy and chewing gum, generally | •23.46% | •22% | •9% | •7% | •6% | •20% | 18.6% | •12% | 15% |
| Chocolate bars | •23.46% | •22% | •9% | •7% | •6% | •20% | 5.5% | •12% | 15% |
| Chocolates (fancy) | •23.46% | •22% | •18% | •7% | •6% | •20% | 18.6% | •12% | 15% |
| Candied cherries & peels | •23.46% | •22% | •9% | •7% | •6% | •20% | 18.6% | •12% | 0% |
| Candy for cooking | 23.46% | •22% | •9% | •7% | •6% | •6% | 18.6% | •12% | 0% |
| Chocolate (baking) | 23.46% | •22% | •9% | •7% | •6% | •6% | 5.5% | •12% | 0% |
| **Non-alcoholic beverages** (except milk): | | | | | | | | | |
| Carbonated beverages | 23.46% | 22% | 18% | 14% | •6% | •20% | 18.6% | •12% | 15% |
| Fruit juices without added sugar | 23.46% | 22% | 9% | 14% | 6% | 20% | 18.6% | 6% | 15% |
| Fruit juices with sugar added | 23.46% | •22% | •9% | •14% | •6% | •20% | 18.6% | •6% | 15% |
| Mineral water | •23.46% | 22% | 9% | 7% | 6% | 6% | •18.6% | 6% | 15% |
| Coffee | 23.46% | 22% | •9% | •7% | 6% | 6% | 5.5% | 6% | 0% |
| Tea | 23.46% | 22% | 9% | •7% | 6% | 6% | 5.5% | 6% | 0% |
| Cocoa | 23.46% | 22% | •9% | 14% | 6% | 6% | 18.6% | 12% | 0% |
| Eggnog | 23.46% | 22% | 9% | 14% | 6% | 20% | 18.6% | 12% | 0% |
| **Alcoholic beverages:** | | | | | | | | | |
| Beer and ale | •23.46% | •22% | •9% | •14% | •6% | •20% | 18.6% | •12% | •15% |
| Spirits | 23.46% | •22% | •18% | 14% | •25% | •20% | 18.6% | •12% | •15% |
| Wine: <13% alcohol | 23.46% | •22% | 9% | 14% | •25% | •20% | 18.6% | •12% | •15% |
| Wine: 13-21% alcohol | 23.46% | •22% | 9% | 14% | •25% | •20% | 18.6% | •6% | •15% |
| Wine: >21% alcohol | 23.46% | •22% | 18% | 14% | •25% | •20% | 18.6% | •6% | •15% |
| Wine: sparkling | 23.46% | •22% | 18% | 14% | •25% | •20% | 18.6% | •12% | •15% |
| Brandy and unidentified champagne | 23.46% | •22% | 18% | •14% | •25% | •20% | 18.6% | •12% | •15% |
| Champagne, etc. if origin identified | 23.46% | •22% | 38% | •14% | •25% | •20% | 18.6% | •12% | •15% |
| **Tobacco (including excise taxes):** | 211% | 611% | 225% | 258% | 226% | 251% | 300% | 194% | 299% |

•Additional excise tax often or always applies. The figures listed do not include these additional taxes.

| **VAT: A Focus on Cars & Motorcycles** | **Sweden** | **Den.** | **Italy** | **Germ.** | **Belg.** | **Neth.** | **France** | **Lux.** | **U.K.** |
|---|---|---|---|---|---|---|---|---|---|
| **Regular VAT rate:** | 23.46% | 22% | 18% | 14% | 20% | 20% | 18.6% | 12% | 15% |
| **Cars:** | | | | | | | | | |
| Engine less than 2,000 cubic centimeters | ⊛23.46% | 22% | 18% | 14% | 25% | ↓$-P↓ | ⊛33.3% | ⊛12% | 23%[1] |
| Engine more than 2,000 cc | ⊛23.46% | 22% | 38% | 14% | 25% | ↓$-P↓ | ⊛33.3% | ⊛12% | 23%[1] |
| Low-pollution, less than $5,000 | ⊛23.46% | 22% | ↑cc↑ | 14% | 25% | 20% | ⊛33.3% | ⊛12% | 23%[1] |
| Low-poll., price more than $5,000, e.g. $20,000 | ⊛23.46% | 22% | ↑cc↑ | 14% | 25% | 37% | ⊛33.3% | ⊛12% | 23%[1] |
| High pollution, price less than $5,000 | ⊛23.46% | 22% | ↑cc↑ | 14% | 25% | 38% | ⊛33.3% | ⊛12% | 23%[1] |
| High-poll., price more than $5,000, e.g. $20,000 | ⊛23.46% | 22% | ↑cc↑ | 14% | 25% | 45% | ⊛33.3% | ⊛12% | 23%[1] |
| For disabled, handicapped | ⊛23.46% | 22% | ↑cc↑ | 14% | 6% | ↑$-P↑ | ⊛18.6% | ⊛12% | 23%[1] |
| **Motorcycles:** | | | | | | | | | |
| Engine less than 240 cc | ⊛23.46% | 22% | 18% | 14% | 25% | ↓$↓ | 18.6% | ⊛12% | 15% |
| Engine 240–350 cc | ⊛23.46% | 22% | 18% | 14% | 25% | ↓$↓ | 33.3% | ⊛12% | 15% |
| Engine more than 350 cc | ⊛23.46% | 22% | 38% | 14% | 25% | ↓$↓ | 33.3% | ⊛12% | 15% |
| Price less than $3,000 | ⊛23.46% | 22% | ↑cc↑ | 14% | 25% | 28% | ↑cc↑ | ⊛12% | 15% |
| Price more than $3,000, e.g., $6,000 | ⊛23.46% | 22% | ↑cc↑ | 14% | 25% | 32% | ↑cc↑ | ⊛12% | 15% |
| Mopeds | ⊛23.46% | 22% | 18% | 14% | 20% | 28% | 18.6% | ⊛12% | 15% |

⊛Excise tax in addition to the VAT not included.

[1] Includes the U.K.'s 10% wholesale tax on cars.

## BUSINESS USE OF CARS:

| **Country:** | **Input Credit?** |
|---|---|
| Germany | Credit allowed |
| Luxembourg | Credit allowed |
| Netherlands | Credit, but 2.5% times the price of car is taxed annually |
| Belgium | Half credit if mixed business and personal use |
| Sweden | No credit for purchases; half credit for leasing |
| Italy | No credit (except for salesmen) |
| United Kingdom | No credit |
| France | No credit |
| Denmark | No credit |

## BUSINESS MEALS AND ENTERTAINMENT:

| **Country:** | **Input Credit?** |
|---|---|
| Germany | Credit allowed |
| Luxembourg | Credit allowed |
| Sweden | No credit for wine & alcohol if non-deductible for income taxes |
| Italy | No credit for meals & drinks |
| Netherlands | No credit for amounts greater than $250 per year |
| Belgium | No credit, except for salesmen |
| United Kingdom | No credit (unless a foreigner is being entertained) |
| France | No credit |
| Denmark | No credit (none for hotel expenses, either) |

# Appendix Four: Primary Sources

Most of the specific information on rates and tax bases in European value-added tax systems was gleaned from International Bureau of Fiscal Documentation, *Guides to European Taxation, Volume 4, Value-Added Tax in Europe* (3 Volumes) (1981-1987). The French Ambassador to the United States graciously supplied a copy of a French-language summary of the French *taxe sur la valuer ajoutée* to fill in gaps in the International Bureau's outline of the French VAT. Information on different taxes as a share of gross domestic product in various countries comes from the United States Department of the Treasury, *Tax Reform for Fairness, Simplicity, and Economic Growth, Volume 3, Value-Added Tax* (1984). The analysis of the distributional impacts of the various European value-added taxes and other potential value-added tax plans was performed on a computer model created in conjunction with Citizens for Tax Justice's March 1988 report on state sales and excise taxes, *Nickels & Dimes: How Sales & Excise Taxes Add Up in the 50 States*.

# CITIZENS FOR TAX JUSTICE

Citizens for Tax Justice was formed in 1979 to give ordinary people a greater voice in the development of the tax laws at the national, state and local levels. Against the armies of special-interest lobbyists for corporations and the wealthy, CTJ fights for a fair shake for middle- and low-income families, based on the idea that people should pay taxes according to their ability to pay them. Dan Rostenkowski, chairman of the House Ways and Means Committee, has called CTJ "the average taxpayer's voice in Washington." *The Washington Monthly* ranked CTJ at the top of its 1988 list of the "best public interest groups."

CTJ's studies on corporate tax avoidance, including *130 Reasons Why We Need Tax Reform* (1986), *Corporate Taxpayers & Corporate Freeloaders* (1985) and *Money for Nothing: The Failure of Corporate Tax Incentives*, 1981-84 (1986), have been widely cited for their important role in the enactment of the Tax Reform Act of 1986—pathbreaking federal legislation that curbed tax shelters for corporations and the rich and cut taxes for poor and middle-income families. Indeed, *The Washington Post* called CTJ's reports a "key turning point" in the tax reform debate that "had the effect of touching a spark to kindling" and "helping to raise public ire against corporate tax evaders." *The Wall Street Journal* said that CTJ "helped propel the tax-overhaul effort," and the Associated Press reported that CTJ's studies "assured that something would be done...to make profitable companies pay their share."

Other recent CTJ reports include: *The Corporate Tax Comeback: Corporate Income Taxes After Tax Reform* (1988), *Nickels & Dimes: How Sales & Excise Taxes Add Up in the 50 States* (1988), and *The Sorry State of State Taxes* (1987).

Articles written by CTJ staff members frequently appear in *The New York Times*, *The Washington Post*, *The Los Angeles Times*, *The New Republic* and other publications—big and small—across the country. Through press, television and radio coverage, CTJ's message gets out—to the public and policymakers alike. Working with a growing network of labor, community and church groups from every part of the country, CTJ's goal is to make taxes a better deal for middle- and low-income American families.

Citizens for Tax Justice
1311 L Street, NW
Washington, DC 20005
(202) 626-3780

Mr. McIntyre. The point is that the compliance costs for business and the administrative costs for the Government would be at least as enormous as they are for the current tax structure. We don't need to duplicate the IRS all over again.

Chairman Rostenkowski. I don't want to take a position on a value-added tax one way or the other, but we did have some time ago a seminar of Vito Tanzi. Have you ever heard him? He is an economist with the IMF. At our seminar, he went through a value-added tax and it was astonishing how cumbersome and how expensive and how much the administration of it was. That always stuck with me.

Ernie, would you like to make some comment?

Mr. Christian. Yes, sir, I sure would. I would like to make a lot of comments. It is inconceivable to me, Mr. Chairman, that the simple calculation of value-sold minus value-purchased is any complication for a business at all. That is inconceivable to me compared to the present corporate income tax.

All companies have to handle the income tax today. All companies handle other kinds of State and local taxes which very closely resemble value-added taxes. In particular, if you were substituting a value-added tax for the present corporate income tax and present income tax on people in general, those people out there that vote and who go through the annual agony of April 15 presently, wouldn't even have to file returns, Mr. Chairman.

There is nothing involved at all. A business has a very simple, basic accounting process to do and I assure you that any business that can even begin to comply with the present corporate income tax and payroll tax system could easily handle the VAT administration at the business level and have plenty of time left over to do something productive.

The idea that people get confused about is that a VAT causes the cost of consumption to go up—the price of consumer goods to go up. That is basically not true. People can't on the one hand say that a VAT is a hidden tax and then in the very same breath say it is going to cause consumer prices to go up. Those are totally inconsistent, Mr. Chairman.

You at one point I believe, mentioned something about a gasoline tax?

Chairman Rostenkowski. I do that quite often, Mr. Christian. It falls on a lot of deaf ears, but I do it quite often.

Mr. Christian. I would point out to you that the gasoline tax is essentially a value-added tax, which I am sure you know.

Chairman Rostenkowski. Isn't a value-added tax a sales tax?

Mr. Christian. No, sir. The difference between the two is quite profound. I think the best way to illustrate it is this way: A value-added tax is imposed on companies—those people who produce and sell value. The base of the tax is the value they produce and sell. They are the people who pay the tax, just the way they pay the corporate income tax today.

A company that pays a dollar of VAT instead of paying a dollar of corporate income tax, for example, is in exactly the same position. They have got to try, to the extent they can, to pass that dollar on to the consumer. But the burden is on them. They have got to move it.

With a sales tax, the situation is reversed. With a sales tax, the consumer is the person who pays the tax. He has then got the burden, if he can, to try to pass it back to the business. There is a considerable difference between those two.

Chairman ROSTENKOWSKI. I will tell you one thing, Mr. Christian. As far as the legislation is concerned that is the easiest tax in the world to impose on people. I mean it is kind of a hidden tax and you know, the increments are maybe 1, 2, 3, and then all of a sudden, they are 10, 12. And that just legislation in the tax area gives me concern, because we aren't really meeting our responsibilities. Not that we couldn't get something out of this committee with respect to revenues that are necessary, but what will we do with it when we get out of this committee?

We can't pass it on the floor of the House of Representatives. There isn't the stomach out there to talk about whether or not it is an energy tax or a consumer tax of sorts. The Congress is just very apprehensive about, in my opinion, meeting its responsibility on doing something about the deficit.

Dr. Thorning.

Ms. THORNING. Mr. Chairman, may I just say a couple of things.

One, I think your question about complexity and the veto, Tanzi of the IMF, is well taken, but I also was at a General Accounting Office seminar recently and one of the economists there on loan from the Government of New Zealand talked to us about the recent implementation in 1986 of New Zealand's VAT, which is a single-rate tax invoice credit, and subtraction method for small firms.

According to his account, it was introduced very smoothly because there is only one rate. It is not complex, and the administrative cost is no greater—I would like to correct Mr. McIntyre—I didn't say it was going to be so cumbersome. I said per dollar collected it costs no more to collect than the personal income tax.

It may well be that a country would do better to diversify its tax base rather than try to say add on a hundred billion in income taxes to reduce the Federal deficit. It might be better for our trade balance if we didn't add on a hundred billion in income taxes and then try to export those price increases when we are selling things abroad.

At least VAT can be rebated on exports so it doesn't hinder our products flowing abroad. So there may be real good reasons why we ought to look at changing the composition of our tax base, particularly if we could implement a single-rate value-added tax, say 5 percent.

By the way, I would also like to mention one thing in response to Mr. Swanstrom's testimony. Some research by Dr. Jacob Stockfish at the Rand Institute, showed that countries that implemented VATs over the past 10 or 15 years—he did a study of 15 countries that implemented a VAT with those that did not have a VAT—and he found that the rate of change in Government expenditures was not greater in the countries that implemented the VAT than in those that did not put a VAT in place.

So I think there is at least some academic research suggesting VAT's do not necessarily contribute to higher levels of government spending.

Chairman ROSTENKOWSKI. Mr. Swanstrom.

Mr. **Swanstrom**. There is other academic research that has come to the opposite conclusion, too. Mention was made of New Zealand. I was there a few months after they applied the value-added tax and the country was in the middle of a recession primarily because of the VAT. The New Zealanders I talked to said many of them were flying to Australia to buy goods to save from paying the VAT which did hurt the country.

Complexity of a VAT would be magnified greatly by having multiple rates. Most of the estimates of VAT involve one rate but I don't think it makes sense to say some things will be exempted from a VAT. Typically, in Europe, the rates vary from 1 to 36 percent. This great variance adds to the administrative cost which for the U.S. Government alone, would probably raise the administrative cost by 50 to 60 percent.

Mr. **Christian**. Mr. Chairman, I personally doubt that the negatives my friend Tom and other people have asserted are pertinent to consideration of an American VAT by this committee possibly at some point in the future. People are talking about things that I doubt would ever be done here. There is no reason to talk about the techicalities of the invoice and credit VAT they have in Europe. That is just a set of mechanics. There is absolutely no reason whatsoever in an American VAT why we should have exemptions at all. We would have one single rate.

In addition, everybody is talking about adding a VAT on to the existing system. I am not talking about adding a VAT on. I personally would be opposed to adding a VAT on to the existing system. I am talking about substituting a VAT for payroll taxes, which are highly regressive, and for both personal and corporate income taxes to the extent the money is available.

But most importantly, I am talking about the potential of a VAT to broaden the base of the tax system in the United States to pick up an appropriate amount of taxes from the value of goods that are produced abroad by foreign labor and foreign capital, and imported into our market and do not bear their share of the costs of the U.S. Government.

In the simplified example I gave in my testimony dealing with substitution, I pointed out that we could pick up $50 billion per year for immediate deficit reduction without any increase in taxes in the United States. At the same time, we could, in my view, vastly improve our system by substituting an American VAT, which would be simple, not the stuff that people are talking about, for existing taxes.

Chairman **Rostenkowski**. Mr. McIntyre, you want to close this up?

Mr. **McIntyre**. Mr. Chairman, I hope that when you consider the long-term savings problem you consider who is going to have to pay for fixing it. I think that is really the fundamental issue we face here in this country.

Chairman **Rostenkowski**. Well, I think it is really our responsibility here on the Committee on Ways and Means because the broad jurisdiction that we have to expose as many Members, even if not physically present, expose them to the testimony that you have given about the problems that are going to be out there and the citizens in our country just do not think about saving anymore. People assume Social Security is a retirement program.

We do everything we possibly can to suggest that that is what it is all about. Nobody puts money away anymore for the rainy day. That is something that I think we should become very concerned about.

We have gone through several seminars that I put together with the Ways and Means Committee membership. We have had academicians with us for a long weekend discussing just what our problems are and what direction we are going in.

They have been very useful to us and that is why when you sit down in an atmosphere away from Washington where the telephone isn't going to interrupt you and you have a long weekend for discussing things, certain ideas really make an impression on you.

Jim, do you want to ask any questions? Let me just finish my statement.

You know, my predecessor in this chair was very big on a value-added tax. They didn't like that in Oregon. But there is no question about it, ladies and gentlemen, we are a committee that is out looking for revenue and looking for ways to do something that is as painless as taxes can be and this is certainly getting higher on a priority list with a membership who are looking for other avenues of revenue.

Now, I don't know when it will come even in my service here in Congress as chairman of the committee, but everything is on the table. When you mentioned that I talk about energy taxes or gasoline taxes, I am not too popular on the floor. I get a lot of applause but I only get 40 votes and you can't pass anything with 40 votes.

But there is something that I think the American citizen has to recognize. People are paying for gas or the consumption of gas at a heck of a lot greater price all over the world than they are here in the United States. I just think that it serves a useful purpose. We have got to start building smaller cars.

If they turn the taps off on us again overseas and the prices go up, and if we aren't building an automobile that can consume less gas, we are going to be stymied here like we were in the Carter era and that scares me.

I just think if we are going to wake up the American people, we wake them up by hitting them in the pocketbook, particularly if you are going to be able to conserve energy and get fuel-efficient automobiles.

You know, I am not clairvoyant. George Bush will be saying this in about 2 years. I will bet money he will be saying it in 2 years if he is going to be a responsible President.

I expect him to be responsible. Mr. Moody.

Mr. MOODY. Thank you, Mr. Chairman.

I apologize to the panel that I had to be out of the room for much of your testimony. I certainly found what I heard very interesting. I will read your testimony very carefully.

Mr. McIntyre, do you think there is a direct causal relationship between the lack of savings and our foreign trade deficit?

Mr. MCINTYRE. I think it is pretty much equivalent now. Basically, when we have a savings shortage that means we are not saving enough to finance our domestic investment. When we don't have enough to finance it, we have to borrow the money from abroad.

When we borrow the money from abroad, that means foreigners are investing here rather than buying our goods. You have to run a trade deficit in that circumstance.

Mr. MOODY. Of course, our imports aren't capital goods. They tend to be——

Mr. MCINTYRE. Right, but if we are bringing in foreign financial investment, then that is dollars of what we pay for imports coming back not to buy our exports but to pay for our savings shortfall. Economists, you know, you are one, will tell you that it has to be equivalent, that the savings shortage, if you have one, is equivalent to the trade deficit.

And vice versa. We always had trade surpluses when we ran savings surpluses. The only difference is a small statistical discrepancy.

Mr. MOODY. I was looking at that. So they send us Toyotas, Hondas, VCR's. We send them pieces of paper, financial obligations and they send them back to buy part of Manhattan or part of Los Angeles or put it in Treasury or other financial obligations they own.

If they did the latter, they could build indefinitely, couldn't they, without any day of reckoning?

Mr. MCINTYRE. No.

Mr. MOODY. I am thinking what is the cap on the process here?

Mr. MCINTYRE. I don't know if there is a cap, but certainly as time goes by our children will be paying more and more of their output to finance foreign debt.

Mr. MOODY. If they keep lending to our children as rapidly as they have been lending to us?

Mr. MCINTYRE. Then they are dumber than we think I guess is the short answer. Every country has to meet its day of reckoning.

Mr. MOODY. Your other comments and earlier testimony has focused on the distributional effects. There may be some policies which we see distributional effects suffer, but we get macro effects or investment effects or savings effects that we like. To what extent should we let economic policy increase the rate of savings be captive to distributional concerns?

Mr. MCINTYRE. Well, I think we tried the experiment, Mr. Moody, of ignoring distributional issues in hopes of increasing savings in the early eighties and it turned out to be a colossal failure.

We just increased consumption in ways that were narrowly targeted to the wealthy. I think now the answer is it didn't work and we ought to reduce their consumption by raising their taxes.

I don't think you will see a decrease in their savings as a result, at least not significantly. In fact, a lower rate of return on savings is probably the best things for savings we could find right now because there are an awful lot of people who have decided they don't have to save anymore because they have built up so much wealth with the stock market boom and high interest rates.

Mr. MOODY. In 1981 the chairman spoke about what happened in this committee. I want the record to show I was not on the committee when those things happened. But we tried one experiment with ignoring distributional. That may not be our one and only experiment.

That was one particular experiment.

Mr. McIntyre. It was a rather wide ranging one. It essentially gave the "savings and investment" lobbyists, as they would style themselves, everything they wanted. In the ensuing years, they gave back nothing to the economy and that is the problem.

If, in fact, personal savings had gone up by 5 percent of the GNP or whatever their silly prediction was, we wouldn't have the problem today.

Mr. Moody. How do you respond to the respectable group of informed opinion out there that says the 1981 experiment never really had a chance because of tight monetary policy. When we turn on the deficit spigot or using the right analogy, we stepped hard on the fiscal deficit pedal, we slammed hard on the monetary brakes.

Mr. McIntyre. That is the whole point. These kinds of policies, unless the Fed wants to let go with inflation, almost inevitably lead to high interest rates. That is the choice.

The Fed said no more inflation and, therefore, we got high interest rates. The Fed could have let inflation go. We would have had high inflation and that would have been politically intolerable, and probably bad for the country as well.

Mr. Moody. But we saw, as certain candidates were apt to point out in several elections subsequently, it was not long after those big deficits that interest rates, nominal interest rates, and inflation started to drop rather precipitously.

Mr. McIntyre. Absolutely. What the Fed did was successful. They lowered inflation rates and nominal interest rates. Real rates remain very high but that is the usual product of running a savings shortfall.

The eighties are really the first time that has ever happened in this country.

Mr. Moody. I didn't mean to focus only on Mr. McIntyre. The other panelists want to comment on any of my three questions?

Ms. Thorning. Yes. I would like to say one thing, Mr. Moody, about the response of savers to after tax rates of return. I think there is a substantial body of evidence as evidenced in the work by John Shoven of Stanford, by the CEA Chairman Michael Boskin, that does suggest savers do respond to higher after tax rates of return.

Mr. Moody. In the expected direction, not in the negative direction.

Ms. Thorning. Right. Not in the negative direction as Mr. McIntyresuggested. If you look at the recent scholarly work by Vinti and Wise on the recent impact on IRA and Freeberg and Skinner have recently done work on IRA's and these independent academic researchers have determined people did respond to the higher after tax rates.

Mr. Moody. It is not true they just moved their assets around?

Ms. Thorning. That is right. It isn't true they just shifted money around from place to pace.

Mr. Moody. It was rational to borrow money to take out an IRA which didn't increase savings.

Ms. THORNING. Yes, but they adjusted for that and found there was some of that going on but the bulk of the saving that was done came from foregoing consumption, actually represented new saving. Another point that I would like to raise, and perhaps is worth considering, sometimes when you talk about directional issues and you look at particular taxes, the income tax, Social Security taxes, other types of taxes, it is important to not just look at the regressivity or progressivity of individual taxes, but you need to look at how Federal outlays are allocated and look at who is receiving the benefits of Government outlays.

It is important to see who is paying all the dividends of taxes and assess the burdens and then look at who is getting the benefits to assess the total impact of the Federal Government's use of resources.

Mr. MOODY. At the margin on the spending side of the budget we were not cutting economic support programs while spending the money on military, wouldn't you agree?

Ms. THORNING. That is true.

Mr. MOODY. So it was regressive as a derivative of previous policies. We were regressive on both spending and taxing side, would you agree, in the 1981 through 1988 period?

Ms. THORNING. Well, transfer payments have gone up—payments to persons have gone up substantially over the——

Mr. MOODY. But it is a non-means test of the transfers that have gone up most dramatically, right? You can't claim Social Security is very progressive. It is somewhat progressive.

Would you agree with that?

Ms. THORNING. Yes.

Mr. MOODY. Either of the other gentlemen have a comment on the three or four points I raised? Do you have a comment on this question of whether distributional effects, how heavily should they be weighed as we try to design policies to increase savings, for example?

Mr. CHRISTIAN. I have no comment on that, Mr. Moody.

Mr. SWANSTROM. I don't either.

Mr. MOODY. Politically they have become very important to us. We can't ignore them.

Chairman ROSTENKOWSKI. Any wrap-up comments?

Jim, anything?

Mr. MOODY. Thank you very much. Very interesting.

Chairman ROSTENKOWSKI. OK, Ernie.

Mr. CHRISTIAN. I want to say that this is an historic event of some minor significance. I think in the last 20-odd years I have been before your committee about 25 times. This is the first time I ever told you how to raise taxes instead of lower them.

Chairman ROSTENKOWSKI. Thank you very much for joining us. The committee stands adjourned to meet at 10 o'clock tomorrow morning.

[Whereupon, at 3:50 p.m. the committee adjourned, to be reconvened the following day at 10 a.m.]

# NATIONAL SAVINGS RATE OF THE UNITED STATES AND ITS TRADING PARTNERS

---

THURSDAY, APRIL 20, 1989

House of Representatives,
Committee on Ways and Means,
*Washington, DC.*

The committee met, pursuant to call, at 10 a.m., in room 1100, Longworth House Office Building, Hon. Dan Rostenkowski (chairman of the committee) presiding.

Chairman Rostenkowski. The committee will come to order.

This morning the committee will continue to receive testimony on long-term strategies for programs within the jurisdiction of the Committee on Ways and Means. Yesterday we heard about two trends that concern the committee: the decline in the national savings rate and the growing gap in income distribution.

Today we have asked four experts to look beyond the numbers and comment in broad terms on the implication these trends have for our future. We would also like to know why we should care about these trends and what kind of long-term policies we should consider to reverse these trends.

Our panelists are Larry Summers, who will arrive in a few minutes, John Shoven from Stanford, Hugh Heclo from George Mason University, and Joe Pechman from the Brookings Institution.

Gentlemen, welcome to the committee. We look forward to your recommendations. Joe, why don't you begin?

## STATEMENT OF JOSEPH A. PECHMAN, PH.D., SENIOR FELLOW EMERITUS, THE BROOKINGS INSTITUTION, AND PRESIDENT, AMERICAN ECONOMIC ASSOCIATION

Mr. Pechman. Thank you, Mr. Chairman.

It is always a pleasure to appear before this committee.

At this time I would like to talk about the distribution of tax burdens, which is something that I understand Robert Reischauer testified on yesterday. I would like to supplement his calculations, focusing mostly on the top 1 and 5 percent of the income distribution, and then draw some implications for tax policies.

The figures that I look at are somewhat different from those that are in the green book and in Reischauer's testimony. What I do at Brookings, as many of you may know, is to prepare an overall distribution of income based upon census data and tax data.

The census data do not cover all income classes adequately and, in effect, what I do is merge the two sets of data to get an overall income distribution. This permits me to calculate the average effective rates throughout the income distribution, including Federal, State and local taxes.

If you will look at table one attached to my testimony, you will see the results of these calculations for selected years from 1966 to 1988. Basically, what this table shows is that the average effective tax rates in most of the income distribution have changed relatively little over the past 20 years.

What is very, very striking is that the top of the income distribution has had an enormous reduction in its tax burden. The top 1 percent, for example, had its effective rate reduced from almost 40 percent in 1966 to 25 percent in 1985. Of course, this has been reversed somewhat by the progressive effect of the Tax Act of 1986, so that in 1988 we are back to 26.8 percent. But this is still lower than it was even in 1980 and, of course, about 40 percent lower than it was in 1966.

The same thing holds true for the top 5 percent, whose tax burden was cut by 16 percent between 1966 and 1985. This is the total tax burden, including Federal, State, and local taxes.

My conclusion from these numbers is that what we have been doing over the past decade, largely through rate cuts in the top income brackets under the individual income tax and through the generous investment credit and depreciation allowances under corporation income tax, is to erode or reduce the tax burden on capital incomes in the top income brackets.

This has only been partially reversed in 1986. In actual magnitude, the total reduction in income tax at this year's income levels between 1980 and the present, including the Tax Act of 1986, is on the order of $200 million a year. If we had the 1980 income tax system, we would now be raising $200 million more from the income taxes than we do today.

In these circumstances, when and if you turn to revenue sources, we must pay attention to the large reductions in the tax burdens of the wealthy. It is time, it seems to me, to redress that balance. We have been going the other way for two decades.

As you know, I am not in favor of punitive rates and punitive taxation. What I would do is to build on the Tax Reform Act of 1986 in two ways. First, I would broaden the tax base more than we did in 1986 in order to avoid the need for increasing tax rates even more than we have to.

I would also modernize the excise tax system which has not been adjusted for inflation for at least three decades.

But even after all of that is done, I think it is clear that there will not be enough revenue to make a substantial dent in the deficit in the next 5 years.

In these circumstances, it seems to me that we should turn to the broad-base income tax to get the additional revenue. If all of the tax rates are increased by 1 percentage point—the 15 to 16 percent, 28 to 29 percent, and the corporate rate from 34 to 45—you would raise $25 billion today and $30 billion 5 years from now. I submit that this is a much better way to raise the revenue and also to balance the budget rather than to reduce socially needed programs or to turn to other taxes that would be much more regressive.

In particular in view of these facts, it would be particularly unfair to turn to something like the value-added tax to raise additional revenue. First, because the distribution tax burden has become much less progressive but more importantly, as I indicated earlier, we should not store $200 million of revenue lost from the income tax by a value-added tax. This, of course, would make the tax system even less progressive.

In conclusion, it seems to me that the facts are clear. I don't think that there is a revenue bind. Income tax rates are low. We have reduced them very substantially and if and when you turn to tax increases, you should look at the income taxes for more revenue.

Thank you very much, Mr. Chairman.

[The statement of Mr. Pechman follows:]

# The Distribution of Tax Burdens
by
Joseph A. Pechman

Statement before the Ways and Means Committee, April 20, 1989

I am pleased to have this opportunity to appear before this committee to examine recent changes in the distribution of tax burdens. I would like to summarize some of the work I have done at Brookings and then discuss the implications of this work for current policy.

## Effective Tax Rates, 1966-1988

I have been estimating the distribution of income before and after taxes for the last two decades on the basis of a unique file of the incomes of the nation's families and unrelated individuals. This file--which is known as the MERGE File-- brings together the data for large samples of family units from the Consumer Population Survey of the Bureau of the Census and the IRS sample of individual income tax returns. Estimates of the taxes paid to the federal, state, and local governments were made for each unit in the samples and then blown up to national totals to obtain a distribution of tax burdens by income classes. MERGE files were developed for the years 1966, 1970, and 1975, and the 1975 file was projected to 1980 and 1985. The results of this project are summarized in my book, Who Paid the Taxes, 1966-85? (Brookings Institution, 1987).

The conclusions of this study are summarized in the attached table 1, which gives the effective rates of federal, state, and local taxes by population percentiles for the years 1966, 1970, 1975, 1980, and 1985. (We made estimates on the basis of eight different sets of incidence variants, but I am concentrating on the variant which I consider the most realistic, namely, that taxes on labor are borne by labor and taxes on capital are borne by capital.) According to these estimates, the tax burdens of the bottom 90 percent of the income distribution have not changed very much during this period of almost two decades. By contrast, the tax burdens of the top ten percent of the income distribution declined, especially those of the top 5 percent and 1 percent of the distribution. For the top 5 percent, the reduction in effective tax rates between 1966 and 1985 amounted to 20 percent (from 32.7 percent to 26.0 percent); for the top 1 percent, the reduction was 36 percent (from 39.67 percent to 25.3 percent).

The explanation of this large drop in tax burdens of the highest income recipients is that, throughout this period, top individual income tax rates were reduced sharply and the corporation income tax dwindled to relative obscurity at the federal level. In 1966, the highest individual income tax rate was 70 percent; by 1985, it had been cut to 50 percent. The effective corporate tax rate declined from 32.8 percent to 16 percent during this period. The reduction in the corporate income tax reflected primarily the investment incentives introduced in the 1960s and liberalized in the 1970s and 1980s. The proliferation of personal deductions (e.g., IRAs) and tax shelters were also major factors in the reduction of the tax burdens in the top part of the income distribution.

Since 1985, the distribution of tax burdens has changed largely as a result of the enactment of the landmark Tax Reform Act of 1986. This act increased the progressivity of the tax system in several respects; first, it raised the personal exemptions, the standard deduction, and the earned income credit, all of which reduced the tax burdens at the lower levels of income; second, it raised the corporate income tax by about 20 percent; and, third, it eliminated IRAs and other deductions and removed the tax advantages of tax shelters. The question is whether this change in tax policy--a change which I heartily supported and still support--had much of an effect on the overall distribution of tax burdens.

My response to this question is that the 1986 act increased tax progressivity, but by only a small fraction of the progressivity decline in the prior two decades. Unfortunately, I have not been able to prepare a MERGE file for years later than 1985. As a substitute, I estimated the distribution of tax burdens in 1988 on the basis of the recent estimates of the changes in the distribution of federal taxes by the Congressional budget office. (For the purpose of this exercise, I assumed that there was no change in the effective state-local tax rates between 1985 and 1988.) The last column of table 1 shows my estimate of the combined federal, state and local effective tax rates in 1988, which includes the effect of the increase in social security tax rates since 1985 and the Tax Reform Act of 1986.

It is clear from table 1 that the progressivity of the U.S. tax system increased between 1985 and 1988, but not much. Taxes declined somewhat in the first three deciles and increased in the top seven. At the very top of the income distribution, the 1986 reform restored about half the reduction in effective tax rates between 1980 and 1985, but left them far below the 1966 levels. Thus, the top 5 percent paid 27.4 percent of their income in taxes in 1988 as compared with 32.7 percent in 1966; the top 1 percent paid 26.8 percent in 1988 as compared with 39.6 percent in 1966.

## Policy Implications

The inescapable conclusion from these figures is that the well-to-do in our society have had very large tax reductions in recent years, while the taxes at the low and middle income levels have not changed very much. In these circumstances, it seems to me that consideration should be given to redressing this imbalance if and when taxes are raised to reduce the deficit.

The first and best alternative would be to continue to broaden the base of the income taxes by eliminating unnecessary deductions and tax favors that remain in the law. Some examples are the exemption of capital gains transferred by gift or at death, numerous fringe benefits that are not taxable to employees, excessive tax benefits of home owners, and the exclusion of all Medicare benefits and part of social security benefits from the tax base. The second alternative would be to raise the excise taxes on liquor, tobacco, and gasoline. These taxes, which are levied on a specific dollar basis per unit, have been eroded by inflation; yet they are important in recouping at least some of the costs imposed upon society by drinkers, smokers, and drivers. At the very least, they should be adjusted for the inflation of the past thirty years, and I would also support even larger increases in oil or gasoline taxes in order to promote energy conservation.

However, as a practical matter, it is clear that income and excise tax reform will not provide enough revenue to achieve a budget balance in the forseeable future. I believe that the additional revenues should be obtained by a flat percentage-point increase in all the income tax rates, both corporate and individual. If the rates were raised by 1, 2, or 3 percentage points, the 15 percent rate would rise to 16, 17, or 18 percent, the 28 percent rate to 29, 30 or 31 percent, and the corporate 34 percent rate to 35, 36, or 37 percent. Each percentage-point increase in these rates would bring in about $33 billion in fiscal year 1994, so that two points would raise half the currently estimated deficit in that year. Now that we have a better tax base, it would be appropriate to use the income taxes to raise additional revenues when necessary. Moreover, a top individual income tax rate of 30 or 31 percent cannot be regarded as punitive or harmful to economic incentives.

What would be inappropriate in my view would be to introduce a value added tax, as some are suggesting. This tax is similar to a retail sales tax, except that the revenues are collected at all stages of the production and distribution process rather than at the retail stage alone. These taxes are regressive and impose unnecessarily heavy burdens on the lower income classes. Our income tax rates are now at their lowest levels in the entire postwar period and income tax liabilities are modest at all income levels. In these circumstances, more revenues should come from the income taxes, which are paid by those who have the ability to pay. There is no reason to impose the burdens of a sales tax on the people who are having the most trouble making ends meet.

The Tax Reform Act of 1986 was a milestone in tax history. Additional reform is needed to close the remaining loopholes and to continue the progress made to eliminate unnecessary deductions. Equally urgent is to get control of the federal budget and this will require higher taxes. Tax reform can help, but I believe it will also be necessary to raise the income tax rates to achieve our budgetary objective. In view of the reduction in tax progressivity in recent years, it would be unconscionable to consider the distinctly inferior alternative of a sales or value-added tax.

Joseph A. Pechman is Senior Fellow Emeritus and formerly Director of Economic Studies at the Brookings Institution.

**Table 1. Effective Rates of Federal, State, and Local Taxes, by Population Decile, Selected Years, 1966-1988[a]**

Percent

| Population percentile[b] | 1966 | 1970 | 1975 | 1980 | 1985 | 1988[c] (est.) |
|---|---|---|---|---|---|---|
| 1st decile[d] | 16.8 | 18.8 | 19.7 | 17.1 | 17.0 | 16.4 |
| 2nd decile | 18.9 | 19.5 | 17.6 | 17.1 | 15.9 | 15.8 |
| 3rd decile | 21.7 | 20.8 | 18.9 | 18.9 | 18.1 | 18.0 |
| 4th decile | 22.6 | 23.2 | 21.7 | 20.8 | 21.2 | 21.5 |
| 5th decile | 22.8 | 24.0 | 23.5 | 22.7 | 23.4 | 23.9 |
| 6th decile | 22.7 | 24.1 | 23.9 | 23.4 | 23.8 | 24.3 |
| 7th decile | 22.7 | 24.3 | 24.2 | 24.4 | 24.7 | 25.2 |
| 8th decile | 23.1 | 24.6 | 24.7 | 25.5 | 25.4 | 25.6 |
| 9th decile | 23.3 | 25.0 | 25.4 | 26.5 | 26.2 | 26.8 |
| 10th decile | 30.1 | 30.7 | 27.8 | 28.5 | 26.4 | 27.7 |
| Top 5 percent | 32.7 | 33.0 | 28.4 | 28.9 | 26.0 | 27.4 |
| Top 1 percent | 39.6 | 39.0 | 29.0 | 28.4 | 25.3 | 26.8 |
| All deciles[e] | 25.2 | 26.1 | 25.0 | 25.3 | 24.5 | 25.4 |

Source: Brookings MERGE files (revised).

a. Assumes corporate income and property taxes are borne by capital income.

b. Arrayed by comprehensive income which includes transfer payments, employee fringe benefits, net imputed rent, and corporate earnings allocated to shareholders.

c. Projected from 1985 on the basis of CBO estimates of changes in effective federal tax rates. Assumes no change in effective state-local tax rates between 1985 and 1988.

d. Includes only units in the sixth to tenth percentiles.

e. Includes negative incomes not shown separately.

Mr. **Dorgan**. Thank you.

Next we will hear from Dr. Heclo.

## STATEMENT OF HUGH HECLO, PH.D., CLARENCE J. ROBINSON PROFESSOR OF PUBLIC AFFAIRS, GEORGE MASON UNIVERSITY

Mr. **Heclo**. Thank you.

I have been asked to comment on the information before this committee regarding income distribution in the United States.

I think the most striking fact about this information developed for the committee is the consistency of the story it tells. This story is one of a widening income gap in the 1970's and 1980's, whether one measures pre-tax cash income or post-tax income with in-kind benefits included, whether one adjusts for family size or not, whether one weights the distribution by families or by numbers of persons.

At the same time, the story of diverging economic fortunes is not restricted to isolated pockets of the population but cuts across the working-age population and their dependents. Thus, growing income disparity is evident among white families and among nonwhite families. Indeed, it is even greater among nonwhite families.

It applies to working age families with children and to such families without children, to married couples and to one-parent families. Only among the elderly has the traditional postwar escalator analogy continued to apply, with older Americans occupying different steps, but all moving up more or less together.

As others have noted, a more appropriate image in the last 15 years for working-age Americans and children dependent on them is one of some people on an "up" escalator and other people on a "down" escalator, especially since 1978.

In my printed statement, I note that according to conventional social science wisdom about the relationship between economic development and growth on the one hand, and equality on the other, this sort of thing isn't supposed to happen.

Likewise, historically there has also been a theory, if you want to get more savings, you have to be willing to tolerate a greater degree of inequality. In the recent American experience, we are getting both. Growing inequality is not buying us higher savings. On the contrary, as we have seen, savings are declining as inequality has increased.

The real issue raised by the committee's evidence on income and tax distribution is not about some grand social science theory of income equality and social justice. The real issue is one of a decent opportunity to make one's way in the world.

Our national tradition has never supported the idea of absolute income equality. Indeed, in our tradition, inequality has always been more tolerable than immobility.

What concerns most Americans, I think, is not the shape of the income distribution, but rather the question of distributing enough economic resources over one's lifetime for purposes that we can all recognize, like buying a house, educating one's children, getting through spells of sickness or unemployment, retooling to keep up with the job market, possibly coping with family breakup, and providing for a decent retirement.

It is in terms of this meat-and-potatoes equality of opportunity that there are grounds for worrying about what has been going on in this country. Statistics showing a widening gap in the income distribution may be symptoms of a larger tendency for more people to be caught up struggling at the margins of the economic mainstream.

This "marginalization" is relevant not simply some fraction of the population below an official poverty line, or a so-called underclass, but extends across broad bands of low- and moderate-income workers and their dependents.

Structural economic changes appear to be creating significantly greater inequality among Americans in terms of their lifetime prospects for material well-being. Since the early 1970's, the proportion of jobs paying enough to afford a basically middle-class standard of living has diminished. Those who had already attained such a standard could often manage to keep up through a variety of means—by sending wives into the labor market, postponing or reducing childbearing, saving less and borrowing more to finance consumption. Those who had not attained such a standard and lacked skills had to struggle harder to attain it and more often failed in the 1970's and 1980's.

All of this is in the immediate past. Let me say a few words about the future.

I think there is a strong likelihood that this divergence in economic fates will continue. Given what has been happening to young children and child poverty rates in the last 15 years, we can expect a future work force containing a higher proportion of young adults from disadvantaged backgrounds.

Likewise, given differences in fertility rates and immigration patterns, we can anticipate that by the year 2000, the proportion of 15 to 24-year-olds who are members of racial or ethnic minorities will increase from one in six to perhaps almost one in three. Their problems are compounding.

Minority and economically disadvantaged youths today are much more likely than others to drop out of high school. It is also clear that if they do stay to obtain their diplomas, the education they have received generally compares quite poorly with that available in suburban schools and better-off neighborhoods; minority and poor youth are concentrated in the bottom fifth of the score distribution on virtually every major standardized test used in this country. At the same time, college enrollment rates for blacks and Hispanics have actually declined from the 1970's to the 1980's.

When you and I were growing up, many poorly educated teens could eventually make the school-to-work transition through blue-collar, craft apprenticeship, and manufacturing jobs. Since the early 1970's, structural economic changes have severely reduced this career-oriented side of the youth labor market. The jobs these young people are finding waiting for them now are more often in the low-paid, unstable, dead-end segments of the service economy. The problem is especially severe among young black males, but by no means is it confined to one race.

In 1974, nearly half of employed black men ages 20 to 24 were in what could be considered career manufacturing jobs—blue-collar craft, operative, foreman work. By 1974, the real median income of black males with income in that age group had risen 68 percent since 1959. By 1984, only about one-quarter of black males 20 to 24 were in such jobs, and the real income for this age group had fallen 44 percent since 1973. For white males of the same age, real median income had risen 28 percent from 1959 to 1973 and fell 32 percent between 1973 and 1984.

If that had happened to you and me, we would call that a depression.

The general deterioration of U.S. economic performance since the early 1970's has adversely affected the income of many youth. Before, from the 1950's to the early 1970's, each successive cohort of young workers could look forward to doing better than its predecessors. Changes in the U.S. economy since 1973 generally halted that escalator of rising real incomes for young Americans.

At the same time, there has been a growing split among young adults engaged in the transition from school to work. Since 1973, those with a college education have been better able to hold their own, and in their later twenties even bounce back from economic troubles.

However, those young men with only a high school degree or less have seen their income positions continue to erode and their economic distance from college youth widen. By 1986, during the fourth year of an economic recovery, young males with only a high school degree actually were earning 7 to 10 percent less than their counterparts had earned in 1959. Those without the degree were earning 20 to 25 percent less than their counterparts in 1959.

The annual earnings advantage of 25- to 29-year-old male college graduates relative to high school graduates, a gap that had ranged from 15 to 18 percent during 1959–79, had grown to 51 percent by 1986. What this means is that a nation that has always aspired to be an opportunity society appears in danger of becoming a two-tier society.

Behind the bare economic statistics lies a complex, interwoven pattern of social disorder. Changes in the U.S. economy are dealing a severe blow to the earnings capacity of many young men and women, particularly those with limited education and skills.

This in turn is one important factor affecting the formation of young families, dimming marriage prospects for young couples and straining those two-parent families where breadwinners lack highly marketable skills. And this compound of economic and social problems is then reflected in the disadvantaged children who are a growing proportion of the Nation's future work force.

Thus between 1974 and 1985, the poverty rate for children in families headed by persons aged 20 to 24 rose from approximately 25 percent to almost 50 percent. Obviously, a major component of this dismal record lies with the growing numbers of one-parent families. Their predicament as sole-earners in the modern labor market, when combined with limited schooling, yields child poverty rates approaching 90 percent. But we should not conclude that the web of misfortune touches only female-headed families.

Among married couples headed by a man with only a high school education, a child poverty rate that had been 6.8 percent in 1973 tripled to 21.6 percent in 1986. In the years ahead, these and other disadvantaged children will be the ones with the most meager prospects for educational attainment and real economic independence.

What to do? It might help if we could try and think of social problems in terms not only of group versus group or this interest versus that interest, but also in terms of a life cycle that we all share. All of us, if we survive, will be the elderly. All of us are the working aged. And in a sense, too, the children are us, because what they are is what the Nation will be.

There are many recommendations one might make. We need to inject a more genuine vocational education in high schools and strengthen the transition from school to work.

We should revamp unemployment insurance and other income maintenance programs for working aged persons, so that they shift from being a means of passive support to a system of retooling for success in the labor market.

Of course, the bills have to be paid. I think we should consider innovative ways to earmark and recycle funds from later stages of the life cycle, when many affluent elderly are doing quite well, to early stages of life, where we need much greater investments in the Nation's children.

Yesterday, the Senate passed a $150 billion-plus, multiyear rescue plan for the thrift industry. It is hard to believe we can't be equally creative in finding ways to pay for greater investment in the children that we must count on to be savers of the future.

Everyone will have his or her own laundry list of recommendations. In the past, we have too often deluded ourselves into thinking that there is some simple, one-dimensional answer to solve a neat, one-dimensional problem. So, the cycle of activism and then disillusionment recurs as we discover that "the problem" is really an interconnected web of social and economic conditions that responds only slowly if at all to our interventions.

My main recommendation would be that we set in motion a process for trying better to understanding what is happening. Modest executive branch efforts to develop and analyze social indicators in the 1960's and 1970's were largely dismantled in the budget-cutting frenzy of the 1980's, the equivalent of a self-imposed lobotomy on Government.

We frequently create national commissions to engage in firefighting operations for particular problems of the moment, but a short-term crisis response is not what we need in this case. As this century draws to a close amid immense social and economic changes, it would be wise to consider the establishment of a bipartisan and expert study commission to report on basic social trends in the United States, because in addition to the trade and the budget deficit, we appear to be facing a mounting social deficit.

Now is a good time to take stock of where we are headed.

[The statement of Mr. Heclo follows:]

Statement of Hugh Heclo
before the
House Ways and Means Committee
April 20, 1989
Washington, D.C.

Mr. Chairman:

Thank you for this opportunity to appear before the Committee. I am especially grateful to participate in a somewhat novel but valuable experiment that offers Members an opportunity to pause in the daily rush and consider the longer-term direction of the nation's business.

I am a professor of public affairs at George Mason University, a former government professor at Harvard and former senior fellow at the Brookings Institution. My main area of expertise lies in international problems of social policy and institutional change.

The material on income and tax distribution presented in this year's "Green Book" is important because it lends strong support to a view that many have come to based not only on statistical studies but also on everyday observation -- namely, a concern that America is becoming a more unequal society, a society where many people are doing quite well and where many and growing numbers of other people are bumping along at the margins.

Given the conceptual and methodological problems in any discussion of economic inequality, the most striking fact about this information developed for the Committee is the consistency of the story it tells. This story is one of a widening income gap in the 1970s and 1980s, whether one measures pre-tax cash income or post-tax income with in-kind benefits included, whether one adjusts for family size or not, whether one weighs the distribution by families or by numbers of persons. At the same time the story of diverging economic fortunes is not restricted to isolated pockets of the population but cuts across the working-age population and their dependents. Growing income disparity is evident among white families and among non-white families (indeed it is even greater among non-white families). It applies to working-age families with children and to such families without children, to married couples and to one-parent families. (Tables 35-41 of the Green Book). Only among the elderly has the traditional postwar escalator analogy continued to apply, with older Americas occupying different steps, but all moving up more or less together. As others have noted, a more appropriate image in the last 15 years for working-age Americans and children dependent on them is one of some people on an "up" escalator and other people on a "down" escalator.

If what we are seeing is something real going on in society, and not a statistical artifact, then the facts are out-racing our theories. Conventional wisdom on this subject is summed up in the so-called Kuznet's curve. This thesis, which has received a good deal of empirical support, argues that inequality traces a more or less inverted U-shaped pattern, increasing in the early stages of industrialization and economic development and then leveling off and decreasing as economic growth proceeds. This seems a good approximation of the 150 years of U.S. history between 1820 and 1970. The question is, what happens after the Kuznet's curve has curved? As economic growth and development continue, should we keep expecting more equality and leveling, no trend, a repeat of the cycle toward greater inequality, or what?

Those who have criticized allegedly "liberal" social scientists for being pre-occupied with income inequality have a valid point. Conditions of equality or inequality within the overall distribution of income are not something that matters greatly to ordinary Americans. Within our national tradition, inequality is and has been much more tolerable than immobility. Statistics on the annual distribution of income may show considerable inequality, but if families and individuals are able to keep moving around within this distribution, the multi-year distribution of income could be quite equal. It is this preference for egalitarian churning -- shorthand for equal opportunity -- that truly epitomizes Americans' standards for thinking about equality and inequality.

Clearly the Committee's data on income inequality in 1973, 1979 and 1987 offer only static snapshots. We know that during these years the gap between those at or near the bottom and those at or near the top has increased, but from these statistics we cannot judge degrees of movement among the economic strata.

Trends in the distribution of opportunities for mobility are complex. There is some evidence to suggest that a greater equalization of life chances (i.e., a narrowing of the multiyear distribution of income) has not accompanied economic growth in recent years. Sectors at the top of the labor market have been thriving; those in more or less the bottom two-fifths of the labor market have been losing ground, not just in relative, but often in absolute terms during the last 15 years. When this sort of sustained stagnation or reduction in real income hits you or me, it is called a depression.

The real issue raised by the Committee's evidence on income and tax distribution is not about some grand social science theory of income equality and social justice. The real issue is one of a decent opportunity to make one's way in the world. What concerns most people is not their place in the income distribution, but rather the question of distributing enough economic resources over one's lifetime for purposes of buying a home, educating children, getting through spells of sickness or unemployment, retooling to keep up with the job market, possibly coping with family breakup, and providing for a decent retirement. It is in terms of this meat-and-potatoes equality of opportunity that there are grounds for worrying about what has been going on in this country. Statistics showing a widening gap in the income distribution may be symptoms of a larger tendency for more people to be caught up struggling at the margins of the economic mainstream. This marginalization is relevant not simply to some fraction of the population below an official poverty line, or a so-called underclass, but extends across broad bands of low- and moderate-income workers and their dependents.

Structural economic changes appear to be creating significantly greater inequality among Americans in terms of their lifetime prospects for material well-being. Since the early 1970s, the proportion of jobs paying enough to afford a basically middle class standard of living has diminished. Those who had already attained such a standard could often manage to keep up through a variety of means (sending wives into the labor market, postponing or reducing childbearing, saving less and borrowing more to finance consumption). Those who had not attained such a standard and lacked skills had to struggle harder to attain it and more often failed in the 1970s and 1980s.

There is a strong likelihood that this divergence in economic fates will continue. Given what has been happening to young children and child poverty rates in the last 15 years, we can expect a future workforce containing a higher proportion of young adults from disadvantaged backgrounds. Likewise, given differences in fertility rates and immigration patterns, we can anticipate that by the year 2000 the proportion of 15- to 24-year-olds who are members of racial or ethnic minorities will increase from one in six to perhaps almost one in three. Their problems are compounding. Minority and economically disadvantaged youths today are much more likely than others to drop out of high school. It is also clear that if they do stay to obtain their diplomas, the education they have received generally compares quite poorly with that available in suburban schools and better-off neighborhoods; minority and poor youth are concentrated in the bottom fifth of the score distribution on virtually every major standardized test used in this country. At the same time, college enrollment rates for blacks and Hispanics have actually declined from the 1970s to the 1980s.

There was a time when many poorly educated teens could eventually make the school-to-work transition through blue-collar, craft apprenticeship, and manufacturing jobs. Since the early 1970s, structural economic changes have severely reduced this career-oriented side of the youth labor market. Today those whose formal schooling stops with high school are entering the service/retail trade sector of the economy at almost the same rates at which college-educated youths entered this sector in 1960. But the jobs they find waiting for them are now more often in the low-paid, unstable, dead-end segments of the service economy. The problem is especially severe among young black males, but by no means is it confined to one race. In 1974 nearly half of employed black men ages 20-24 were in what could be considered career manufacturing jobs (blue-collar craft, operative, foreman work). By 1974 the real median income of black males with income in that age group had risen 68 percent since 1959. By 1984 only about one-quarter of black males 20-24 were in such jobs, and the real income for this age group had fallen 44 percent since 1973. For white males of the same age, real median income had risen 28 percent from 1959 to 1973 and fell 32 percent between 1973 and 1984.

The general deterioration of U.S. economic performance since the early 1970s has adversely affected the income of many youth. Before, from the 1950s to the early 1970s, each successive cohort of young workers could look forward to doing better than its predecessors. Changes in the U.S. economy since 1973 generally halted that escalator of rising real incomes for young Americans.

At the same time there has been a growing split among young adults engaged in the transition from school to work. Since 1973 those with a college education have been better able to hold their own and in their later twenties even bounce back from economic troubles. However, those young men with only a high school degree or less have seen their income positions continue to erode and their economic distance from college youth widen. By 1986 -- during the fourth year of an economic recovery -- young males with only a high school degree actually were earning 7-10 percent less than their counterparts had earned in 1959. Those without the degree were earning 20-25 percent less than their counterparts in 1959. The annual earnings advantage of 25- to 29-year-old male college graduates relative to high school graduates, a gap that had ranged from 15 to 18 percent during 1959-79, had grown to 51 percent by 1986.

Behind the bare economic statistics lies a complex, interwoven pattern of social disorder. Changes in the U.S. economy are dealing a severe blow to the earnings capacity of many young men and women, particularly those with limited education and skills. This in turn is one important factor affecting the formation of young families, dimming marriage prospects for young couples and straining those two-parent families where breadwinners lack highly marketable skills. And this compound of economic and social problems is then reflected in the disadvantaged children who are a growing proportion of the nation's future work force. Thus between 1974 and 1985 the poverty rate for children in families headed by persons aged 20 to 24 rose from approximately 25 percent to almost 50 percent. Obviously a major component of this dismal record lies in the growing proportion of never-married mothers in this and other young age groups. Their predicament as sole-earners in the modern labor market, when combined with limited schooling, yields child poverty rates approaching 90 percent. But we should not conclude that the web of misfortune touches only female-headed families. Among married couples headed by a man with only a high school education, a child poverty rate that had been 6.8 percent in 1973 tripled to 21.6 percent in 1986. In the years ahead, these and other disadvantaged children will be the ones with the most meager prospects for educational attainment and real economic independence.

There are many recommendations one might make.

We need to inject a more genuine vocational education in high schools and strengthen the transition from school to work.

We should revamp unemployment insurance and other income maintenance programs for working aged persons, so that they shift from being a means of passive support to a system of retraining for success in the labor market.

We should consider innovative ways to earmark and recycle funds from later stages of the life cycle, when many affluent elderly are doing quite well, to early stages of life where we need much greater investments in the nation's children.

Expanding basic health insurance and pension coverage would do much to help make many struggling Americans less economically marginal.

Everyone will have his or her own laundry list of recommendations. In the past we have too often deluded ourselves into thinking that there is some simply, one-dimensional answer to solve a neat, one-dimensional social problem. The cycle of activism and then disillusionment recurs as we discover that "the problem" is really an interconnected web of social and economic conditions that responds only slowly if at all to our interventions.

My main recommendation would be that we set in motion a process for trying better to understand what is happening. Modest executive branch efforts to develop and analyze social indicators in the 1960s and 1970s were largely dismantled in the budget-cutting frenzy of the 1980s -- the equivalent of a self-imposed lobotomy on government. We frequently create national commissions to engage in fire-fighting operations for particular problems of the moment, but a crisis response is not what we need in this case. As this century draws to a close amid immense social and economic changes, it would be wise to consider the establishment of a bipartisan and expert study commission to report on basic social trends in the United States.

Mr. PEASE. Thank you very much, Dr. Heclo.
We will hear now from Dr. Shoven.

## STATEMENT OF JOHN B. SHOVEN, PH.D., CHAIRMAN, DEPARTMENT OF ECONOMICS, STANFORD UNIVERSITY, AND DIRECTOR, CENTER FOR ECONOMIC POLICY RESEARCH, AND RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. SHOVEN. Let me congratulate the committee for instituting a hearing. Too little attention is paid to the problems that will face the next generation of American workers. As this session will highlight, our policy actions today are going to have a profound impact on the economic well-being of the next generation of workers.

Second, let me say I think that you have chosen the right topic to initiate the series. I think there is no greater threat to the next generation of workers than our low savings rate.

National saving can be broken into components of personal saving, business saving, and Government savings. At each level, its definition is the difference between economics and consumption. At the Government level, saving is simply the Government surplus.

Unfortunately, we haven't had a Government surplus, but a deficit. That deficit is negative or "dis-savings." The level of savings in the United States has fallen from 7 and 9 percent of GNP in the fifties and sixties and seventies to 2 and 3 percent of GNP in the last 3 years. About half of this decrease is due to private savings, the fall of private savings, and half is due to the massive increase in Government deficits.

The large Federal deficit is offset only a little bit by the State and local government surpluses. My handout shows that 50 percent of reduction in national savings is due to decreased Government savings and 50 percent to a decrease in private savings.

What are the consequences of these low savings rates? The first consequence is that the national wealth will grow very slowly. Over the short run, wealth can fluctuate due to reevaluation of existing assets, but in the long run, it is determined by the additions to assets.

A 2 percent of GNP savings rate translates to a two-thirds of 1 percent growth rate in national wealth, which translates to a zero percentage growth in wealth per capita and wealth per worker.

This is a near certain recipe for economic stagnation. Now, investment has also fallen in the United States. In the decade of the seventies, it was 7.6 percent of GNP, today net investment is 5.7 percent of GNP. Still, it is a bit of a mystery, until you look at numbers carefully, how can we be investing when we are only saving 2.1 percent? We are doing it with foreign borrowed money to the tune of 3.6 percent of GNP.

We are never going to eliminate the money and close the trade imbalance unless we deal with the imbalance. We need to raise savings or lower investment. It is clear to me that the preferable way is to raise savings.

Now, if we don't do anything about the imbalance between savings and investment, what are the consequences? Relative to financing this fairly modest level of new investment ourselves, if we continue to borrow on it instead, Americans will continue to be poorer.

We already know that the American workers 30 years from now will have an elderly population to help support. If we continue to finance our investments with borrowed money, that generation of workers also are going to have a very large group of claimants from abroad, and they may have to service a large foreign debt.

It is unlikely at that time that foreigners will continue to loan money to the United States. They are making these loans to provide for their own retirement problems, and at that time, they are going to want that, the servicemen are going to want repayment.

That generation of workers is going to be squeezed unless we change our policies. The real wage rate has not grown much in 20 years. The current set of policies could lead to the real wage continuing to stagnate, and we could have a period as long as 50 years without significant progress on real wages.

Those are the stakes involved in improving our savings situation. Now, what should our goal be in terms of saving and investment? I think the goal is pretty easy to state. It is simply to return to the fifties, sixties, and seventies. If we could do that, we would return to a situation where investment was about 25 percent higher than it is now, and then savings was 3 or 4 times higher than now.

So what we basically have to do is get back to what you might call the good old days. In terms of numbers, the goal in terms of national savings should be about 8 percent of GNP. That is 5 to 6 percentage points higher than it has been the last 3 years. We should aim for that by 1995.

If we believe that the economy can grow at about 2.5 percent a year since we are already at full employment, then consumption growth will have to be held to 1.5 percent a year for the first half of the next decade.

Now comes the hard part that says we need to do it. The question is, How should we do it? It is my opinion, since the Government and private sector have shared in the slide, that both sides will have to contribute to its restoration.

Now, I think there are things the Government can do to encourage both types of savings. On the private side, I think that the balance of the evidence is that individual retirement accounts work, that they worked better before we increased the limitations on them. I would favor their liberalization.

A second, and I think a larger point is that we need to recognize the form of most private savings. Most private savings takes the form of pension contributions. People save through their pension plan. Pension contributions are way down in the eighties, precisely because financial assets have performed so well.

The higher rates of return experienced by pension funds have allowed companies to fund their obligations with reduced contribution rates. This is an almost perverse response to the higher rates of return that we have realized in this particular decade.

The only way we can change that is to design tax policies which would encourage payroll savings plans, plans where the employer matches at some rate, employee contributions, and other kinds of contribution plans. I think the tax laws should be changed in such a way as to encourage the contribution plans and to discourage defined benefit plans.

One proposal to at least consider would allow employees to save before-tax dollars in payroll savings plans and to also allow them tax preferences at the time of withdrawal if the money is maintained at least 7 years. At the very least, if you are trying to encourage private savings, you need to recognize the form that takes place, and that is pensions.

A third thing I would mention is the need for the Tax Code to be written in a way to encourage savings more. The big issue here is inflation indexation. The failure to index for inflation, again in my mind, is the major flaw of the 1986 tax reform.

Let me give a quick example. If you invested $6,000 in 1966 in the Standard and Poors 500 and you sold that at the end of 1987, you would have sold out for almost $20,000. That almost $14,000 capital gain would be taxed, and you would pay almost $4,000 in taxes.

However, if you adjust for inflation, that $20,000 will not buy what the $6,000 would when you made the investment. You have actually lost money, and yet the government is going to tax you to the tune of $4,000 or close to $4,000.

So, I feel this failure to index capital gains can lead to exorbitant tax rates and make it a wealth tax, and I would suggest that it would encourage savings to take that wealth tax out.

Another thing I think that could encourage savings is to recognize that we have got this major restructuring going on among corporations of the United States. Stockholders are realizing capital gains on their stocks when the companies are taken over. These unrealized and unexpected capital gains are increasing their consumption and decreasing private savings.

The answer is to examine a corporate tax flow cash and move away from a separate corporate income tax on equity of profits. I don't think that the 8-percent goal for national savings can be reached without doing something about the deficit. I think we need to completely eliminate the deficit.

In fact, my target for the Federal Government savings would be a 2-percent GNP surplus by the late 1990's. This would be accomplished by balancing the budget, excluding Social Security, and at the same time allowing Social Security to accumulate the surplus as designed into the system in the 1983 reform.

To assure this goal, I recommend that the Gramm-Rudman-Hollings deficit targets be redefined in terms of the on-budget items only. This will help assure us that the surpluses are not simply offset by the deficits in the rest of the budget.

You might wonder how important is the government deficit in terms of economic performance for the next generation. Three Brookings economists, Henry Aaron, Barry Bosworth, and Gary Burtless estimated that last year.

Let me summarize by saying that if we achieved an 8-percent national savings rate instead of the 2.5-percent savings rate that we have now, by 2020, their numbers indicate real wages would be 15 percent higher. Well, we haven't had a 15-percent growth rate, growth in real wages in the last 30 years.

I can think of no single action which would have this dramatic of an effect of getting our savings rate back to where it was in the fifties, sixties, and seventies. If we need to achieve a balanced budget or actually a total unified surplus, the question is how to do it. While I believe that we should work to hold down expenditures and to see if money can't be saved in some programs, I am sure they can, but I am also one who thinks that we will need a tax increase to achieve this goal.

In terms of taxes, I think we need to keep in mind what is the purpose of lowering the deficit? In my mind, the purpose is to increase savings. I think this itself indicates fairly strongly that we want to tax consumption and not income.

If the additional revenue needed was relatively minor, say 1 percent of GNP, I think we might be able to do with selected increases in excise taxes. Perhaps a gasoline tax, cigarette taxes, liquor taxes, and the like.

However, if we need a lot of revenue, and I think we probably will, perhaps 2 percent of GNP, then I think the best instrument is a broad-based consumption tax like a national sales tax. They have a lot of advantages. One advantage—sometimes a political disadvantage is that they raise a lot of revenue at relatively low rates.

Second—I was going to say that even with a program of income relief for low-income households, tax relief for low-income households, it can raise money. It would tax participants in the underground economy. I think that is a desired instrument if we want to raise a lot of revenue.

Certainly it would be a burden on people. Any program of increasing savings from its current level to 8 percent is going to cause painful adjustments.

Let me summarize what my main points are. I think the consequences of the low level of national savings is slow economic growth and no growth perhaps in wages.

Second, I believe that our goals should be to return to the savings levels of the fifties, sixties, and seventies, roughly an 8-percent rate of net national savings. Third, the difference between an 8 and 2.5 percent savings rate could amount to about a 15-percent change in real wages by 2020.

The steps I advocate are liberalizing IRA's, increasing tax incentives for payroll savings plan, indexing the Tax Code with respect to capital income, and replacing the corporate income tax with a corporate tax flow tax.

In terms of other items on the Government side, change Gramm-Rudman-Hollings so it is on budget deficit alone and try to establish a plan to balance the budget, excluding Social Security. Attempt to curtail expenditure growth where possible, but plan sometime in the next 5 years to increase taxes.

Taxes should be on consumption rather than income. One thing I strongly urge, I urge immediately, would be to have the U.S. Treasury begin to develop a practical plan implementing a VAT. People say it would take 2 years to figure out how to do it. We should be figuring out how to do it now in a contingency sense.

That completes my testimony. I hope you continue to work on this longrun program. I think the stakes are very high.

[The statement of Mr. Shoven follows:]

# TESTIMONY OF JOHN B. SHOVEN

CHAIRMAN, DEPARTMENT OF ECONOMICS, STANFORD UNIVERSITY
DIRECTOR, CENTER FOR ECONOMIC POLICY RESEARCH, STANFORD UNIVERSITY
RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH

First, let me congratulate the Committee and its Chairman for initiating this series of hearings on long term economic issues and strategies for the U.S. Too little attention is paid to the problems that will face the next generation of American workers. As this session highlights, our policy actions today can have a profound impact on their economic well-being. And, second, let me say that the initial topic which you have chosen to address is the appropriate one. In my opinion the greatest threat to the next generation of Americans (and to American political leadership in the world) is our low rate of net national saving.

I think the concept of national saving is now clear to all of us. Net national saving is the national output that we don't consume, but rather devote to increasing national wealth. The "net" adjective simply refers to the fact that net saving is the difference between national income net of depreciation and national consumption. The dynamics of wealth creation are the same at the household and national levels. Saving is the major determinant of the change in national wealth.

National saving can be decomposed into personal saving, business saving, and government saving. At each level, though, its definition remains income less consumption. At the government level, saving is simply the government surplus. If the federal government runs a deficit, that deficit amounts to negative saving or dissaving.

The level of net national saving in the U.S. ranged from 7-9 percent of GNP in the 1950s, 1960s, and 1970s. However, it has plummeted to the 2-3 percent of GNP range in 1986-88. About half of the decrease is due to a fall in the level of private saving and half is due to a massive increase in government deficits (the aggregate of the federal government deficit, offset somewhat by the combined surpluses of state and local governments). The extreme shift in the numbers is shown below.

| | 1985-1987 | 1970-1979 | Difference |
|---|---|---|---|
| Private Saving | 5.5 | 8.9 | (3.4) |
| Plus federal government saving | (4.9) | (1.9) | (3.0) |
| Plus state and local government saving | 1.5 | 0.9 | 0.6 |
| Equals national saving | 2.1 | 7.9 | (5.8) |

---

Source: Overconsumption: The Challenge to U.S. Economic Policy, George N. Hatsopoulos, Paul R. Krugman, and James M. Poterba. American Business Conference, New York and Washington, March 1989.

What are the consequences of such an extremely low saving rate? First, in the long run, national wealth will grow only very slowly. Over the short run real wealth fluctuates due to revaluations of existing assets. But in the long run, the growth of real wealth is determined by additions to assets. A 2 percent of GNP saving rate translates to a growth rate of real national wealth of about 2/3 of one percent (0.67%) and a zero percent growth rate in per capita or per worker wealth. This is a near certain recipe for economic stagnation.

Net domestic investment has also fallen from 7.6 percent of GNP for the decade of the 1970s to 5.7 percent for the recent 1985-87 period. These figures are shown below.

| | 1985-1987 | 1970-1979 | Difference |
|---|---|---|---|
| Net National Saving | 2.1 | 7.9 | (5.8) |
| Equals: Net Domestic saving | 5.7 | 7.6 | (1.9) |
| Plus: Net U.S. Investment Abroad | (3.6) | 0.3 | (3.9) |

Source: Overconsumption: The Challenge to U.S. Economic Policy, George N. Hatsopoulos, Paul R. Krugman, and James M. Poterba. American Business Conference, New York and Washington, March 1989.

Financing investment at the level of 5.7 percent of GNP with saving of 2.1 percent requires that we borrow abroad or sell our domestic assets to foreigners to the tune of 3.6 percent of GNP. The trade imbalance and corresponding capital flows are a direct consequence of the imbalance of national saving and investment. In order to stop our accumulation of foreign debt, we must either raise net national saving or lower domestic investment. The preferred choice is obviously the former.

How will the current mismatch between national saving and investment affect the future? Relative to financing the same level of new investment ourselves, Americans will be poorer. We can already safely forecast that the economy of thirty years from now will need to provide for a much larger elderly retired population. A larger fraction of the production will have to be devoted to the aged. If we continue to accumulate foreign debt at the rate of the past few years, foreigners will also have a claim on a significant fraction of our national product. Given that the countries now providing us with the funds for our spending spree (such as Japan, Taiwan, and even the Netherlands and the U.K.) have similar demographic patterns to our own, there is a strong likelihood that they will demand payments at that time on their accumulated obligations. That is, they will not then fall into the trap of loaning us additional money to service the assets which they already own. After all, their investments in this country are part of their provision for their own aging population.

The combination of a large dependent elderly population and a large foreign debt to service will clearly squeeze the next generation of workers. Their after tax share of GNP will almost certainly be less than that of today's workers. The American dream of a doubling of real income levels each generation (which seemed realistic in the 1950s and 60s) will be completely shattered. The real after tax wages of American workers in 2020 may not be much, if any, higher than fifty years before. If that turns out to be the case, then the U.S. standard of living will trail that of our competitors. The consequences of our current behavior will not necessarily lead to a sudden collapse in our economy, but may lead to a very stagnant economic environment. It is hard to believe that the U.S. can remain a world power in such circumstances.

What can we do to prevent this? We can't do much about demographics. What we must do is to stop accumulating foreign obligations and do everything possible to increase the rate of economic growth. By so doing, we will be enlarging the economic pie available next century and reducing the claimants upon it. Stimulating growth and reducing and eliminating foreign borrowing both require changing national saving, investment, and consumption. In terms of these variables, we should return at least to the levels of the 1950s, 60s and 70s. Those decades were characterized by a rate of net investment which was 25 percent higher than in the most recent years and a rate of net domestic saving three or four times recent experience. National saving slightly exceeded national investment, allowing us not only to fund the increments to our own capital stock (our new plants and equipment, etc.) but also to provide some lending abroad. This position of being a net lender rather than a large net borrower on international financial markets would strengthen our political as well as economic position in the world.

The goal in terms of national saving should be a rate which is at least 8 percent of GNP, some 5 to 6 percentage points higher than in the past few years. We should aim to reach that goal by 1995. That means consumption needs to grow more slowly than income in each of the next five to six years.

If we think the full employment economy can grow at an inflation adjusted rate of 2.5 percent per year, then real consumption growth will have to be held to a rate of 1.5 percent per year for the first half of the next decade.

Now comes the hard part -- how can we increase saving (or depress the growth in consumption) by this much? It is my opinion that just as both the government and the private sector contributed to the slide in national saving, both sides will have to share in its restoration. There are several policies which would encourage businesses and households to save more. First, I believe that the best evidence indicates that Individual Retirement Accounts can be a contributor to national saving. I favor their liberalization. Second, a great deal of private saving occurs in work related pension plans. Pension contributions are way down in the 1980s precisely because financial assets have performed so well. The high rates of return experienced by pension funds have allowed companies to fund their obligations with reduced contribution rates. This almost perverse response to high rates of return can be changed only by designing tax policies to encourage payroll saving plans (where the employer matches at some rate employee contributions) and other defined contribution pension plans. The tax law should favor these sorts of plans relative to defined benefit plans. One proposal to at least consider would allow employees to save before tax dollars in payroll saving plans and give them tax preferences on withdrawal if the money is maintained for at least seven years. At the very least, in trying to design policies to encourage private saving, one needs to take account of the central role of pensions in the saving process.

I think the structure of tax policy should be changed to reward savers more. The big issue here, in my mind, is inflation indexation. The failure to index for inflation is the major flaw in the 1986 Tax Reform. It can translate into exorbitant effective tax rates on capital gains. For example, if one invested $6,000 in the Standard and Poor's 500 common stocks in 1966 and sold at the end of 1987, the portfolio's value would have grown to $19,366. If the $13,366 nominal capital gain is taxed at a 28 percent rate, then $3,742 must be paid to the IRS. However, the consumer price index increased by a factor of 3.52 between 1966 and 1987, meaning that $6,000 in 1966 had the 1987 purchasing power of $21,142. The investment (not counting dividend income) lost real purchasing power and yet the owner was subject to over $3,700 in taxes. I feel that this failure to index capital gains taxes is a strong deterrent to saving in equities in the U.S. The 1984 Treasury proposal was on the right track with respect to indexing.

I also feel that the current corporate tax code, with its strong bias towards debt finance, is a major factor behind the corporate restructurings that are occurring at a record pace. These corporate restructurings result in large realized capital gains for stockholders. These unanticipated realized capital gains have increased aggregate consumption and have depressed saving. The answer on this one is to move towards a corporate cash flow tax and away from a separate corporation income tax on equity profits.

I don't believe that we can reach the goal of an 8 percent savings rate without reducing, even eliminating, the deficit. In fact, my target for federal government saving would be a 2 percent of GNP contribution to national saving in the late 1990s. This would be accomplished by balancing the budget (excluding Social Security) and at the same time allowing Social Security to accumulate the surpluses designed into the system by the 1983 reform. To assure that we reach this goal, I recommend that the Gramm-Rudman-Hollings deficit targets be redefined in terms of the on-budget items only. This will help assure us that the Social Security surpluses are not simply offset by deficits in the rest of the budget.

The government deficit part of the national saving is very important. Just how important was recently estimated by Henry Aaron, Barry Bosworth, and Gary Burtless of the Brookings Institution. They estimated that a permanent reduction of the deficit of only 1.5 percent of GNP would result in real wages which are 4.2 percent higher by 2020. Further, they find that real wages would be 7.1 percent higher if we allow Social Security to accumulate its surpluses (and therefore contribute to national saving) rather than return to pay-as-you-go financing. The 7.1 percent amount in real wages is also the difference between achieving a balanced budget excluding Social Security and only a balanced unified budget.

The figures of the Brookings researchers lead me to estimate that real wages would be approximately 15 percent higher by 2020 if we achieved the goal of an 8 percent national saving rate by 1995 rather than staying in the 2.5 percent range. This is an enormous difference. Real wages haven't grown by 15 percent over the last 30 years. I can think of no other single action we can take which would improve the fortunes of the next generation of workers as much as dramatically increasing our saving rate to its level of the 1970s.

The final tough question is how to reduce the deficit. On this matter, I am one who believes that it is going to require a tax increase. Clearly, expenditure reduction should be examined -- and I believe some money can be saved in agricultural support programs, defense, and capping some entitlement programs. I would favor increasing the fraction of Social Security which is taxable for the relatively well off among the elderly.

In terms of tax increases, we should try to keep in mind that the goal is to increase saving. I think this indicates fairly strongly that we want to tax consumption rather than income. If the additional revenues needed amounts to only 1 percent of GNP, then we could raise the needed revenue by selectively increasing excise taxes. Most of the revenue could be generated by a higher gasoline tax with some contribution from increased taxes on cigarettes and liquor.

If we need a lot of revenue -- perhaps 2 percent of GNP -- then I think the best available instrument would be a broad-based consumption tax, most likely a value-added tax or a national sales tax. Such taxes have a lot of advantages, not the least of which is the ability to raise a great deal of revenue with fairly low rates. Even with a program of relief for low income households, a 5 percent VAT or national sales tax could raise $100 billion. A second advantage is that a VAT or sales tax would also capture some tax revenue from those participating in the underground economy. Of course, people would find a national sales tax a burden. But any program of rectifying our anemic national saving will cause painful adjustments.

Summary

Let me end by summarizing my main points.

- Our current level of national saving will lead to slow economic growth and potentially no growth in real wages.
- Our goal should be to return to the saving level of the 1950s, '60s and '70s. That is, a saving rate of 8 percent of GNP. Such a goal is both ambitious and barely adequate.
- The difference between an 8 percent saving rate and a 2.5 percent rate, cumulated for 30 years, results in a real wage difference of 15 percent by 2020.
- The steps that need to be taken to encourage private saving include:

    liberalized IRAs;

    increased tax incentives for payroll savings plans;

    indexation of the taxation of capital income;

    replacement of the corporation income tax (a tax on equity profits) with a corporate cash flow tax.

- The steps that need to be taken to increase government saving (i.e., decrease the deficit) include:

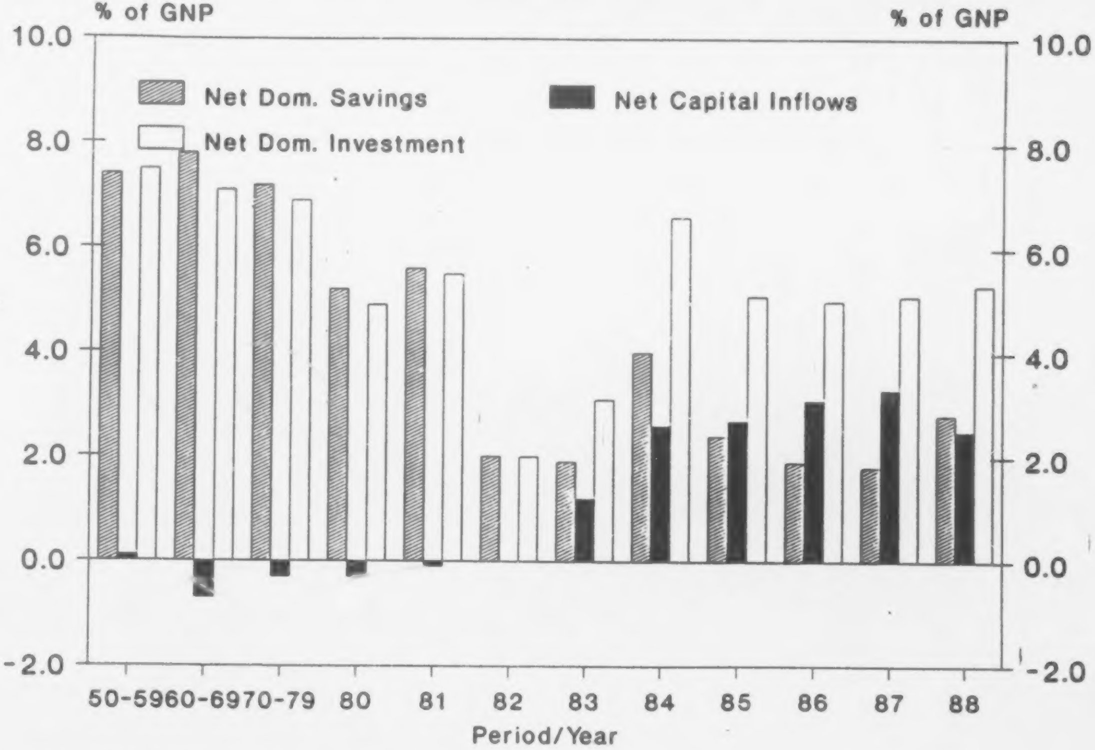
    rewrite Gramm-Rudman-Hollings in terms of the on-budget deficit and establish a plan to balance the budget excluding Social Security;

attempt to curtail expenditure growth in defense and entitlement programs and other expenditure programs;

plan to increase taxes sometime over the next five years. Base the tax increase on consumption rather than income. If a relatively small amount of revenue is needed, use increased taxes on gasoline, cigarettes, and liquor. If a major amount is needed, implement a VAT or national sales tax. I strongly urge that the U.S. Treasury immediately begin to develop a practical plan of implementing a VAT.

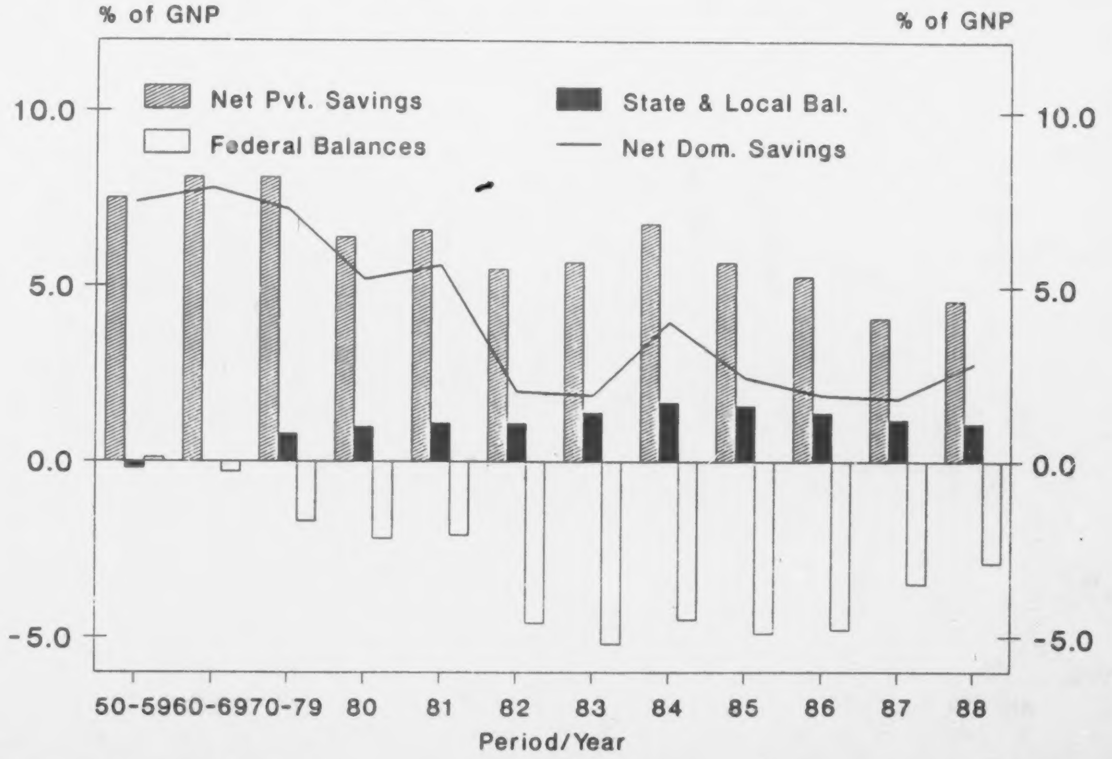
I hope that you continue to work on this long-run problem of inadequate national saving. The stakes are high.

# Net Savings & Investment Flows



Sources: BEA (NIPA Basis)

# Net Savings & Government Budget Balances



Sources: BEA (NIPA Basis)

Chairman Rostenkowski. Thank you.

Dr. Summers.

## STATEMENT OF LAWRENCE H. SUMMERS, PH.D., PROFESSOR OF ECONOMICS, HARVARD UNIVERSITY, AND RESEARCH ASSOCIATE, NATIONAL BUREAU OF ECONOMIC RESEARCH

Mr. Summers. Mr. Chairman, given the time at which I just arrived, I can think of no higher priority than national savings in the form of improved airport infrastructure, but that is not the primary question here.

Chairman Rostenkowski. The Appropriations Committee just cut that budget yesterday.

Mr. Summers. I am glad to hear it. While they are at it, they could change the rules that permit, that make it impossible to charge the guys in Piper Cubs who are holding up a plane with 300 people on which I traveled.

That is probably about as practical and likely to happen as some of the other things we are recommending.

Chairman Rostenkowski. Well, your misfortune, Doctor, is our good fortune.

Mr. Summers. Let me turn to the subject of my testimony, the national savings problem. The problem is, I think, very clear. If you look at my testimony and turn a couple of pages in, you will see a graph of saving rates over the long period over the last 25 years.

The United States does not occupy a position of honor on that graph, with the lowest savings rate. That graph includes data up through 1984. Since 1984, our savings rate has been only half as high as is reflected in that graph.

With the lowest savings rate among the major nations, it is hardly surprising that the American economy has not fared well in terms of providing productivity growth or improved standards of living.

If you turn to the only other graph in my testimony, which is most of the way through, you see that the United States does not occupy a position of honor on that graph, either. The lowest saving rate of the G-7 countries, the lowest growth rate and productivity of the G-7 countries, and the situation has gotten worse since 1980.

The clear policy priority is to increase the national saving rate. How should that national saving rate be increased? I think you should consider measures in four areas: First and most importantly, get the budget deficit down. Everyone agrees that the most potent and reliable way to increase national saving is to reduce Federal dis-saving that has taken out more than half of the private saving that the rest of the economy has generated over the last 8 years.

Reducing Federal deficits will do more to increase national saving in a shorter time than anything else that the Congress can do. From that perspective, I would just note that there is no good news in the recent budgeting agreement to which this committee was only a minor party.

That budget agreement is predicated on ludicrously optimistic economic assumptions, and will not result in meaningful progress in reducing the deficit. I would suggest that the Congress consider the possibility of moving to a budget system in which a private sector economic forecast or a consensus forecast of the private sector was used in generating economic assumptions so as to avoid the kind of dispiriting ritual based on extremely optimistic economic assumptions that we have just seen.

I would echo the comments of my colleague on this panel, John Shoven, that from the perspective of national saving, it is not a matter of great importance whether the budget deficit is brought down through an increase in taxes or through a reduction in spending.

A reduction in spending will reduce public consumption. An increase in taxes will reduce private consumption. In either event, consumption declines and national saving is increased. The choice between those alternatives is not one which we can easily advise on as economists.

It goes to one's values on increased public consumption as opposed to increased private consumption. Top priority, then, reduce the budget deficit. It is my view, given the preferences that the American public and the Congress have revealed for public spending, that it is inconceivable that we will get to a balanced budget, to a budget that is adequate for national saving without tax increases sometime within the next 5 years.

Second, crucial priorities should be accorded to maintaining the Social Security surpluses in order to increase the national saving rate. When those Social Security surpluses are used entirely for the purpose of deficit reduction as they are now being used, and when the Social Security surpluses are responsible for all of the improvement that lies in prospect for the budget deficit, according to official forecasts, those Social Security surpluses are not making a contribution to preparing us for the challenges that lie ahead.

Moving Social Security out of the budget, out of the Gramm-Rudman process and out of public thinking, as it focuses on how to balance or move toward balance in the current year's budget would make a very substantial contribution to national saving and would be appropriate.

It would correspond to the way other entities, State and local governments, corporations, treat their pension funds, and it would recognize that those are there for a very different purpose than balancing this year's budget.

Third, we need to move to increase personal saving. I think that much that was desirable was done in the 1986 Tax Reform Act, but I think the decision in that act to repeal in substantial part the IRA reductions was on balance and done wisely.

It is true in some cases that people made their IRA's contributions by taking money out of accounts that they otherwise had, and in those cases, IRA's made no net contribution to saving. However, that does not appear to be the case for the vast majority of IRA contributors, more than half of whom contribute less than the maximum to which they were legally entitled, more than a third of whom make the contribution at the very last moment.

Furthermore, the evidence suggests that IRA's contribute to national saving in a very different way. Saving, like life insurance, is probably sold more than it is bought. The blizzard of advertisements for IRA's in April that used to exist, served to focus people on the need to save for their retirement and served to motivate them to save more than they otherwise would have.

This is not just idle theory. I have recently studied the behavior of savings in the United States and in Canada. What one sees is that prior to the mid-1970's, savings rates in the two countries had moved pretty much in tandem.

In the seventies, the Canadians instituted a somewhat larger than ours IRA-type program called RRSP's there, and the savings rates thereafter have diverged quite sharply.

Likewise, Japan, prior to World War II, had a lower saving rate than the United States on the institution of a whole set of pro-saving incentives in the postwar period, led to their record savings and record productivity growth performances.

So, stimulating private savings, IRA, restoring IRA's is the first way to do it. A second way to do it, and perhaps an even more attractive way to do it is for those relatively low-income groups that now have IRA eligibility, extend that eligibility to permit saving for higher education, to permit saving for health care problems, to permit saving for the purchase of a new home.

Finally, I think the final step that we can take to encourage saving is to discourage indebtedness. I think the perspective represented by the million-dollar cap on home mortgages was a step that in principle represented a movement in the right direction, and if there are ever proved to be a way of moving further on that that was politically feasible, that would be very desirable.

The limitation on customers' interest deductibility in the 1986 Tax Reform Act was desirable from that perspective as well. Anything that can be done to tighten up on the ability to borrow against home equity would contribute very directly to increasing national saving.

But the problem is not only one of borrowing at the individual level, it is also the case that borrowing at the corporate level, which forces money out of corporations and into individual hands, has also probably contributed to a reduction in national saving and therefore, policies that were successful in reducing corporate leverage by leveling the playing field between debt and equity would probably also be policies that encouraged the rate of national saving.

The problem is very clear. Many of the things that have caused U.S. productivity to slow down are things that are very hard for the Congress to affect. The level of national saving is a policy variable that policy can influence. We should seek to influence it by raising it as soon as possible.

Thank you very much.

[The statement of Mr. Summers follows:]

# TESTIMONY OF LAWRENCE H. SUMMERS
## HARVARD UNIVERSITY

My name is Lawrence Summers. I am a Professor of Economics at Harvard University and a research associate of the National Bureau of Economic Research. My research interests over the last several years have included the determinants of saving behavior, and the impact of savings on economic performance. I applaud this committee's decision to focus attention on America's most important long term economic problem—its low level of national saving.

In my testimony today I will make three points. First, low national saving will retard American economic growth over the next decade unless it is corrected. More urgently, it increases the risk of serious financial disruption. Second, low American national saving results both from large budget deficits and low saving by American households. There is little reason to expect any sharp increase in saving without public policy actions. Third, while deficit reduction is the most potent and reliable way of increasing national saving, there is scope for policy to affect private saving as well.

## I. Low National Saving as a National Problem

Low national saving is our most serious economic problem. As a nation, we consumed publicly and privately close to 98 cents out of every dollar of income we earned over the last several years. As Figure 1 indicates, our current national saving rate is one-third of the rate we enjoyed during the 1970s, when supply side concerns about inadequate saving began to emerge. It is about one-half the saving rate of Great Britain, one-fourth the average saving rate of the major industrialized countries, and one-sixth the saving rate of Japan.

Low national savings mean slow growth in American living standards and reduced American competitiveness. It is the primary cause of our current trade deficit. Nations like the United States that invest more than they save must borrow funds from abroad. The only way foreign funds can come into the United States is for Americans to import more than they export. The US current account deficit of 3.5 percent of GNP in 1987 arose because the United States saved only 2 percent of GNP but invested 5.5 percent of GNP. Japan, on the other hand with saving in excess of investment has enjoyed consistent trade surpluses.

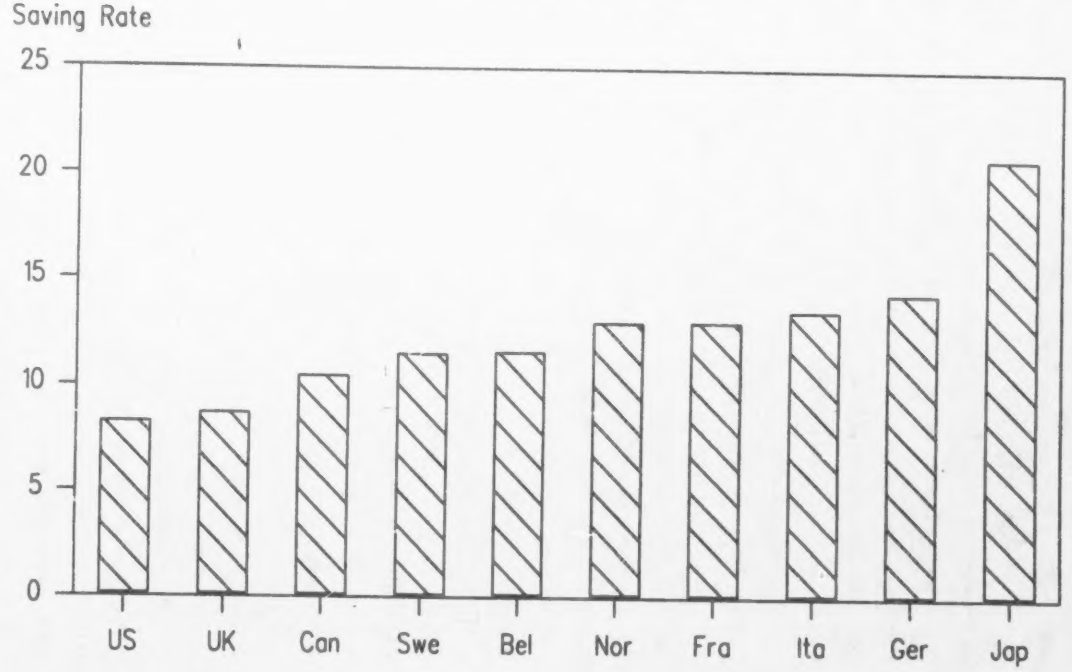
Low national saving also results in low investment. The United States invested less, relative to GNP in plant and equipment during the 1980s than during the 1950s, 1960s, or 1970s. Capital labor ratios have grown less rapidly in the United States than in any of our major competitor nations with disastrous consequences for living standards. Japanese workers have gained ground at 6% a year relative to their American counterparts over the last 15 years as American real wages and family incomes have remained essentially stagnant.

Low national saving leads to reduced investment because it raises the cost of capital by making it scarce. High costs of capital are an important explanation for the myopia often thought to afflict American businessmen. An American businessman, given his costs of capital would be willing to invest only $.37 in return for a dollar six years from now, compared with $.66 for his Japanese counterpart. It is hardly surprising that Japanese managers often appear to take a longer view than their American counterparts.

The combined effect of reduced investment and the foreign financing of a large fraction of what investment does take place is to gradually reduce relative American living standards. This is not something that occurs overnight but as Figure 1 illustrates, there is a clear relationship between national saving rates and rates of growth. The United States is a wealthy

Figure 1

Net National Saving:
A Cross Country Comparison



Annual average, 1960–84

nation and so it can finance a high rate consumption by selling off assets for a long time—but not for ever. Unless, our national saving rate is restored at least to its former level in the 7 percent range it is very likely that we will be overtaken by a number of our competitor nations in the next few years.

A second problem with low rates of national saving is that by causing the US to experience large capital inflows they increase the risks of severe financial disruptions. As long as large Federal deficits continue, the Federal Reserve will have an extremely difficult time in keeping the economy on an even keel. On the one hand, there is the risk that large deficits and robust consumption spending will threaten to overheat the economy forcing the Federal Reserve to jack up interest rates in an effort to head off inflation. This could lead to a repeat of the situation in the early 1980s when a collision between fiscal and monetary policy drove real interest rates way up, caused the dollar to soar hurting the competitiveness of US producers, and leading to a recession. Already, the collision between monetary and fiscal policy has pushed the real value of the dollar up about 10% from its level at the end of 1987.

While there is considerable controversy about what exchange rate adjustments will eventually be necessary if US trade is to be balanced, there is little argument for allowing the dollar to increase sharply at the present time. A strong dollar would after a short adjustment period significantly increase the US trade deficit, leading eventually to a the need for a major dollar depreciation when foreigners recognized that the US international position was not sustainable. Indeed, if national savings remain low, it is difficult to predict the timing of the dollar's fluctuations. It is possible that foreigners will lose confidence in the dollar especially if the Federal Reserve shows signs of being willing to tolerate inflation. In this case, the dollar could fall rapidly causing US interest rates to spike, and leading to a period of stagflation as reduced credit availability led to recession and a weak dollar pushed inflation upwards.

So far, the economy has avoided lurching towards either a surging dollar or a plummeting dollar path. But as long as national savings remains depressed, the possibility of serious instability will continue. Foreign exchange markets are notoriously volatile. If they conclude either that a renewed outbreak of American inflation is likely or that a period of tight money and high interest rates is likely, the value of the dollar could move very far very fast creating nearly impossible dilemmas for economic policymakers.

How serious have these costs of low national saving been so far? The following statistic seems revealing. In 1981, the combined value of all the companies on the American stock market was more than 50% greater than the combined value of all the companies on the Japanese stock market. Today, the combined value of Japanese companies is more than 50% greater than the combined value of American companies despite the fact that Japan has only half the population of the United States. Markets look forward not backwards and so this has to be an ominous sign.

## II. Why is the US National Saving Rate So Low

Chris Carroll and I have recently completed in which we attempted to determine why the US saving rate is so low and why it has declined so precipitously in recent years.[1] We conclude that declines in national saving reflect both increases in Federal deficits and a decrease in the rate of private saving. Private saving which averaged more than 9 percent of net national product has declined to about 6 percent of NNP in recent years. Comparing the current experience with the 1950-1980 period, it appears that more than half of the decline in national saving can be attributed to reduced private saving.

The reasons why private saving has declined in the United States and why it is so low by international standards are far from clear. Our analysis suggests that reductions in saving may to some extent be an unfortunate side effect of social progress. The fact that today's elderly are richer than the remainder of the population and experience less poverty has surely served to reduce fears of old age and discourage saving. So too, the spread of life insurance and disability insurance has also probably served to reduce saving. Finally, the increased availability of debt particularly for the purchase of housing has reduced consumer saving.

It would hardly be desirable to increase old age destitution, discourage the pruchase of insurnce protection, or to make housing more difficult to afford. This suggests that other ways must be found of increasing saving. Unfortunately, without major policy actions it is unlikely that the saving rate will increase very much over the next few years. Widely ballyhooed claims that the maturing of the baby boom will lead to increased saving do not stand up to scrutiny. In fact, saving rates at different ages appear to be surprisingly similar.

---

[1] Lawrence Summers and Chris Carroll "Why is the US National Saving Rate so Low?" Brookings Papers on Economic Activity 1987:2

## III. Policies to Increase National Saving

The fundamental problems faced by the American economy involve its low level of national saving. While there can be no question but that reducing Federal deficits is the most potent and reliable way of increasing the national saving rate in both the short and long run, there is some scope for other policies to affect the level of national saving. Rather than dwelling on the possibilities for reducing the deficit and the minimal progress represented by the budget compromise, I want to focus on these other policy steps.

First, Social Security should be removed from the official budget in order that trust fund surpluses can contribute to increased national saving. These surpluses, which will exceed $100 billion by 1993 must be accumulated in order to meet the needs of the baby boom cohort when it retires. If the trust fund is used to reduce the government deficit it will not be there when it is needed. From a political perspective, moving Social Security off budget will both protect Social Security benefits and increase the pressure for deficit reduction measures by raising the apparent size of the deficit problem.

Second, the "bully pulpit" function of the Presidency should be brought to bear on the problem of inadequate private saving much as it was successfully used to encourage energy conservation. New tangible incentives to saving and disincentives to borrowing should be matched by rhetorical emphasis on the need for increased saving.

While the 1986 Tax Reform Act increased economic efficiency in many ways, the partial revocation of IRA's was unfortunate. because the widespread conviction that IRA's are ineffective in stimulating savings is not supported by the available evidence. While the officially measured personal savings rate has declined since 1981, this should not be taken as evidence that IRAs do not have a substantial impact on savings decisions. Many other factors affecting the savings rate have changed since 1981, so that any positive effect IRA's might have had has been masked. Reduced corporate pension contributions, increased consumer borrowing, and renewed consumer confidence are all possible explanations for the low savings rate. Without the enactment of IRAs, the savings rate might well have fallen even further.

While naive before and after comparisons do not shed much light on the incentive effects of IRAs, other evidence strongly suggests that they have a significant impact on savings. Perhaps the most direct evidence on the question of whether IRA savings represent incremental savings comes from direct surveys of savers. Respondents in the Federal Reserve's Survey of Consumer Finances were asked whether they made IRA contributions and a variety of other questions about their financial affairs. David Wise of Harvard's Kennedy School of Government and Steven Venti of Dartmouth College have conducted a careful statistical analysis of these data on the basis of which they conclude that about half of the money flowing into IRA's represents new savings, about thirty percent of the money comes from the taxes individuals save by making IRA contributions, and only about 20 percent of the money comes from savings that would have taken place anyway had their been no IRAs.

Further evidence that many IRA contributions represent incremental savings is provided by the behavior of IRA contributors. An individual can maximize his tax advantage from making use of an IRA by contributing as early as possible, in January of each tax year. Presumably taxpayers who were simply shifting assets that were being saved anyway would make their IRA contributions early in the tax year. On the other hand, persons for whom IRA contributions represent new savings may not have funds on hand to contribute early in the tax year. Those who contribute late are likely to be contributing new savings, either because it took time to generate them or because they are responding to advertising blitz that financial institutions put on every March and April. IRS statistics reveal that some $15 billion or 45 percent of 1984 IRA contributions were actually made in 1985 suggesting that a significant amount of new savings were generated by IRA contributions.

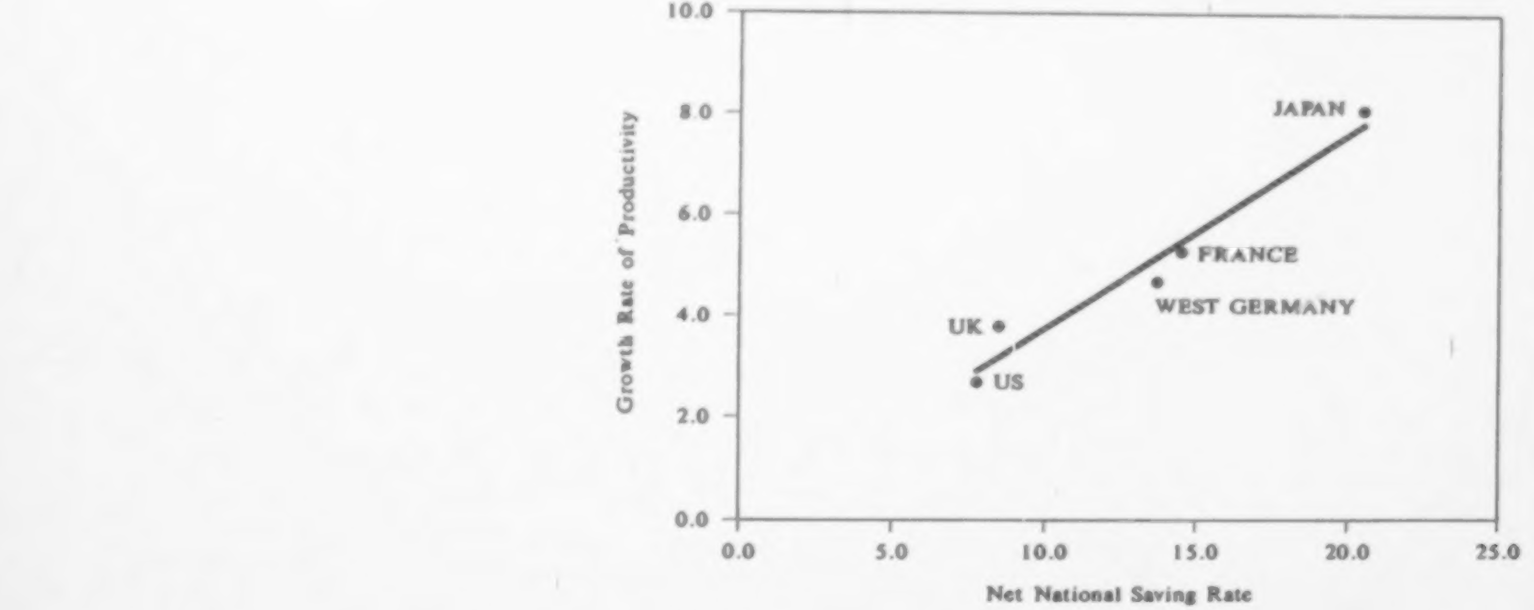
It is important to recognize that tax policies do not affect economic behavior only by altering incentives. They also work indirectly by changing public attitudes and providing incentives for firms to engage in persuasive advertising of a kind they would otherwise not engage in. The existence of IRAs may cause people to focus more on the need to save for their retirement than they otherwise would. They certainly give banks and other financial institutions a strong incentive to remind people of the need to save for retirement. Some suggestive evidence on the long term importance of these effects along with the incentive effects of tax provisions comes from Canada which put a retirement savings program like our IRA program into effect in 1972 and significantly liberalized it in 1976. As Figure 2 illustrates, the savings rate in Canada which had closely tracked that of the United States took off soon after the 1976 liberalization and has exceeded ours ever since.

The weight of the available evidence suggests that IRAs generate a significant amount of saving that would not otherwise have taken place. Under current law, if IRA's were reinstated, the government would lose about 25 cents for each dollar of contribution. If more than one fourth of the money contributed to IRAs represents new savings, they will increase private savings by more than their revenue cost. If this condition is met, the case for maintaining IRAs is clear. Even if it is not, there is still a strong case for savings incentives given that restoration of IRAs would be likely to come at the expense of other tax breaks rather than larger deficits.

Down the road, it would be desirable to broaden the IRA concept to cover other forms of saving such as saving for higher education, emergencies

Figure 2

MANUFACTURING PRODUCTIVITY GROWTH VS. NET NATIONAL SAVING
(AVERAGE ANNUAL PERCENT, 1962-1985)



Sources: U.S. Department of Labor, Bureau of Labor Statistics
Organization for Economic Cooperation and Development

and housing. This would expand the attractiveness of saving and would further encourage promotional activities.

Limitations on corporate financial restructuring would probably also increase national saving by raising corporate retained earnings and reducing payouts to shareholders. Leveraged buyouts leave firms in a position to do no corporate saving because cash flows are exhausted by interest payments and dividends. Share repurchases have also substituted private consumption for corporate saving. Corporate restructuring in which pension fund assets have been used to finance acquisitions have had particularly pernicious effects on national saving and should be curtailed.

Consideration should also be given to new tax incentives for deferred employee compensation. Employees accepting compensation in the form of stock that could not be sold for five years, or special treasury notes that could not be sold would receive a partial tax deduction of perhaps 25% of their compensation. The Treasury would lose revenue only to the extent that people actually made the decision to save by deferring their compensation. Assuming that the typical taxpayer paid tax at a rate of 20%, the program would only cost the Federal government 5 cents for every dollar of extra saving generated. By appropriate manipulation of the withholding rules, employers could be given a strong incentive to sell the saving incentive to their workers, even in case where companies were not publicly traded.

These ideas represent just a few of the many possible strategies that could be used to increase private saving. They are a complement not a substitute for a strategy of Federal deficit reduction. It would not be desirable to adopt tax measures that cost revenue in order to raise the private saving rate except as part of packages that were overall revenue neutral.

Mr. **Moody**. Thank you very much.

Mr. Chairman Rostenkowski?

Chairman **Rostenkowski**. I would just like to thank the panel for their observations. There is so much that I agree with here with respect to the direction that the committee has taken. I think you will remember, Dr. Summers, that provisions in the bill that left the House of Representatives, particularly with IRAs, and even with President Reagan, as I remember, were to protect those. On a personal basis, it was the first time that I had ever seen my daughters become involved in a savings program and that in itself was inspirational.

I think you have to recognize that the cost of it, what was on the Senate side, drove the decision to eliminate the possibility of continuing the program. But, gentlemen, you know, the first bite of the apple will come with this committee.

I couldn't agree more that this slide-by budget is something that entails that we all close our eyes and assume the rosey scenario, but maybe this is a scheme to make us recognize what has to be done before the end of this year, preparing for the next budget cycle.

If it—deficit reduction—doesn't happen, then I will be terribly disappointed. There is no question in my mind that the idea here is to protect the reading lips version of the campaign that took place last November, and as soon as I think we have solved that problem, I am hoping that President Bush will get down to terra firma and start recommending some healthy tax increases, because we are not going to grow on this problem, we are going to have to pay for it.

The only way that I think that is feasible is for this committee to make some disciplined tough recommendations to the floor of the House of Representatives. Whether the chemistry industry out there will agree to ratify what this committee does still remains to be seen.

But I want to thank you all for joining us this morning.

Mr. **Moody**. Thank you.

Mr. Frenzel.

Mr. **Frenzel**. Mr. Chairman, I have no questions.

Mr. **Moody**. Mr. Pickle.

Mr. **Pickle**. No questions.

Mr. **Moody**. Mr. Gradison.

Mr. **Gradison**. Thank you, Mr. Chairman.

Mr. Pechman, I have one question about the table which you distributed. I noted in your corporate tax studies in the past, that you have examined it with different assumptions with regard to the ultimate incidence, because of the uncertainty about where it lies. The assumption is that it is borne by holders of capital, which may be the fact that it is uncertain.

Would it dramatically change your figures with regard to the top 1 of the top 5 percent if you used a 50-50 assumption, as you have in some of your other studies?

Mr. **Pechman**. Not dramatically. The major point is that the corporate tax has been reduced very substantially by provisions other than rate cuts and more recently by the rate cuts.

So that what it would do is moderate the decline in effective tax rates at the top, in effect push some of the tax that is now borne in the higher income classes on to the lower income classes.

But there would still remain a very large reduction of tax rates at the top. Of course, this is the total of Federal, State, and local taxes.

Mr. GRADISON. That leads to my only other question. How important is the State and local element of this? If we just looked at the Federal, which is the only part we have jurisdiction over, would that dramatically affect the figures with regard to the top 1 or top 5?

Mr. PECHMAN. No; the State and local tax system is somewhat progressive, but the differences in rates among the various income classes is very small. If you did it for the Federal tax system, you would get the same results.

Robert Reischauer, who gave testimony yesterday, gave the results from 1977 to 1990. My table goes back to 1966. My guess is that he would get the same results for the Federal tax system back to 1966.

Mr. GRADISON. This isn't a question, but a comment I would like to make with regard to your table one. It strikes me, and it is somewhat surprising to me that virtually all the drop in the effective tax rates of the top 1 and the top 5 percent in this table took place between the years 1966 and 1980. And while indeed, there was a further decline, it is really quite modest compared to the dramatic change earlier.

With regard to the top 1 percent, a rate in 1966 of almost 40 percent in 1966 dropped in 1980 to 28.4 percent, and the 1988 figure dropped to 26.8 percent. Yes; the 1980 figure is before all the recent tax changes. It is surprising to me, that is all.

I just want to note that.

Mr. PECHMAN. The reason is that there was a large reduction in the average effective corporate tax rate during that period. This was the investment result of the tax credit and the very generous depreciation allowances that were given to business enterprises. The ratio of the corporate tax to GNP has declined sharply over the last four decades and that is reflected in these figures.

Mr. GRADISON. Thank you very much.

Mr. MOODY. Thank you.

Mr. Thomas.

Mr. THOMAS. Thank you, Mr. Chairman. Just briefly.

We are in a difficult period. Thank you folks for your testimony. It is always interesting to me that the reaction is to look at the revenue side. I believe it was Dr. Heclo, I was not there for your testimony, but I read it while we were talking.

My concern is we haven't gone back in and examined a lot of entitlement programs and broken them down in terms of which sectors of society that get this aid, how they get it and when. My feeling is that because the majority is attempting to defend retirement programs that were put in place at a time when there was a greater-felt need for the programs, we remain locked into those programs. There are a significant number of folks, many who wind up as single female parents with young children who aren't assisted, and we don't have money available to put programs in for them. I believe when we refuse to reexamine the fundamental rationale that created the entitlement programs, we can't determine whether or not the mix is proper.

We could go back in and redistribute some of the money that is already part of the trillion-plus-dollars-a-year budget. But adding more revenue doesn't get to the fundamental problem, because we can't add enough revenue to address the problem of the misallocation of entitlements.

Mr. HECLO. I think we have to change the way we think about those programs. As opposed to putting one group against another, social insurance programs are designed to smooth out income fluctuations in the life cycle. I believe we ought to think of ways of shifting some of the resources from what is a fairly equal set of resources among those at the later stages of the cycle to those at the early stages.

Mr. THOMAS. I would appreciate any ideas you have of a practical nature to attempt to get my colleagues on the majority side to focus more narrowly on that question from an action point of view.

Thank you very much for your testimony.

Mr. MOODY. Mr. McGrath.

Mr. MCGRATH. Yesterday I made an observation during the same kind of testimony on savings rates and the ability of the Tax Code to change behavior. I was visited by the chairman of Sears, the Discovery Card Division. I fully thought that the changes in the reduced value of the interest deduction on consumer spending in 1986 would have a marked effect on behavior.

It has not. Consumer spending is rising, the consumer debt is rising, and the number of Discovery cards and other cards available are interestingly going higher and higher.

I happen to agree with Larry, that the earlier numbers on the IRA's didn't show any great change in savings rate, and that there was a change in where the savings were coming from in order to take a deduction on the deferral.

I am wondering whether or not the Tax Code can modify either savings or spending decisions made by our taxpayers given all the other constraints and pressures we face? Is that a logical question?

Mr. PECHMAN. Well, many people exaggerate the effect of changes in the tax provisions on economic behavior.

In the case of saving, it has become clear that we really don't know how to increase saving in this country—except by eliminating the dissaving in the Federal Government, which all of us support.

I think that is a sure way of doing it. Reducing the deficit increases saving dollar-for-dollar.

Beyond that, it is hard to say how much of an increase in saving you would get if you used tax gimmicks like IRA's or even converted part of the income tax to a value-added tax.

With respect to the IRA's, at the peak we lost roughly at the peak $12 billion of revenue a year from that one provision.

The people who argue that we should restore the type of IRA's we had earlier have to argue that private saving would increase by more than that. The available facts suggest they can't prove it.

As a consequence, I think that you ought to avoid it.

Mr. McGrath. That has been my point. I remember going back to 1984 when we started talking about the level of tax expenditure for Keoghs, IRA's, and 401(k)'s, I think it was in the neighborhood of $14 billion.

The question was whether or not we were getting the right bang for the buck, given the expenditure. I guess that is the genesis of my question. Can these kinds of tax incentives, for savings make a difference?

If so, are we getting the bang for the buck?

Mr. Summers. Congressman, perhaps I could make three points. First, any, all these revenue numbers on these incentives are a bit misleading. You have to remember that the Government gives up money in the form of my deducting my contribution to my Keogh. Then the Government collects all that money and collects it with interest down the road.

So it is the net figure that you would really want to worry about more, and that is much smaller.

Second, Joe and I will have to check on this. My recollection was that the revenue cost of the IRA's alone was more like $5 billion.

Mr. McGrath. I think the actual guess was $14 billion for all of the programs.

Mr. Pechman. IRA's and Keoghs together amounted to something like $15 billion. The Keoghs were something like $3 or $4 billion, which left net for the IRA's at $12 billion.

Mr. Summers. The revenue estimate in the Packwood 1986 repeal of IRA's was $25 billion or $27 billion over 5 years. It is about $5 billion a year.

I think that a substantial amount of that goes into private savings. Even if it were not the case, I think saying that the Government losing $5 billion doesn't produce $5 billion in extra savings misses the point. If we preserved IRA's in 1986, it would not have meant we would have a $5 billion bigger budget deficit. Something else would have had to give. That would have been something I would have judged to be less valuable than the increased savings.

I don't think the comparison of the revenue costs of IRA's with the private saving they generate is the right way to think about it.

Finally, I would just say that I think there are many things that are more important affecting our savings rate than the tax system.

There is very little that Congress can do about a present ethic in the country. There is very little the Congress can do about the changing demographic structure of the population. When you talk about things where we do have some levers, where we can affect things, I think the tax system is probably as potent a lever that we have.

Mr. McGrath. Larry, you made some reference about the difference between the corporate marginal rate now and the highest individual rate.

This is the first time in, I guess, in history that the corporate rate is higher than the top individual rate.

I am wondering whether or not that has any effect on our savings rate?

Mr. Summers. It tends to encourage the use of corporate debt because it means that the tax advantage of a corporation has to be greater than the tax disadvantage to the individual of holding debt.

I think probably that on net results in some discouragement to national saving, but it is not a fact that we have been successful in quantifying to date.

I think what we can fairly safely say is the reduced corporate tax rate has tended to increase corporate leverage with all the consequences that brings.

Mr. McGrath. Thank you, Mr. Chairman.

Mr. Moody. Thank you.

Mr. Pease.

Mr. Pease. Thank you, Mr. Chairman.

I would like to thank our panel. I was very much impressed by the testimony I was able to hear. I glanced over the rest. I would like to address my comments first to Mr. Pechman. As usual, you provided very thoughtful testimony for the committee. I am particularly interested in your notion that if we have to raise revenue, we ought to do it through the income tax and not through other means preferably, and that we ought to do it by addressing the slippage in progressivity that has occurred over the last couple of decades.

You suggest a couple of ways to do that, some of which make sense to me.

I remember in 1986 when we were considering the tax reform act, we worked very hard to get the distribution by income quintile about the same under the new act as it was under the old act. I think we pretty much succeeded.

But I was struck in relation to the top quintile, that while the effective actual rate people paid in the top quintile was about 21 percent, as I recall, almost half of that group had an effective rate of about 11 percent and the other half had an effective rate of about 31 percent, depending on whether they were heavily invested in tax shelters or not.

By closing down the tax shelters, we were able to raise the effective rate of those who were gaming the system. I remembered ever since that we provided a rather substantial tax cut in the effective rate for those who were not heavily into tax shelters. It seems to me that it would not be out of line for us to try to derive the revenue that we need from that group and from the group then abusing the Tax Code all along and now are paying perhaps 19 or 20 percent versus 11 percent, which leads me to ask whether you have given any thought to a plan that would not raise the rates, per se.

There is some sensitivity to that even on this committee inasmuch as we set the rates in 1986. But rather to limit the full use of the deductions available to high income taxpayers?

Mr. Pechman. Yes; I have given a lot of thought to that and many other provisions that would broaden the tax base. I couldn't agree more with what you said about the further moves to improve the tax system.

There are still a considerable number of personal deductions that cost an enormous amount of revenue and are counterproductive. As I say in my statement, before I would increase tax rates, I would try to broaden the tax base even more than we did in 1986.

Larry Summers mentioned one possibility. That is to put a much lower cap on the deduction for mortgage interest. I think that is long overdue. In fact, I think it is quite outrageous that we provide interest deductions on mortgages up to $1 million.

So that is one way to limit the deduction for home mortgages.

Another way is to examine the deduction for State and local taxes. I think that one of the committees did eliminate the deduction for State and local taxes, but it was restored in the final bill except for the deduction for sales taxes.

Mr. **Pease**. If I could interrupt because my time is very limited, have you thought at all about limiting the availability of the deductions in total for people? In other words, not zeroing in on mortgage interest or State and local taxes or whatever.

How about saying whatever your total deductions are, you don't get credit for all of them?

Mr. **Pechman**. As I recall it, if, for example, you left all the deductions where they are now and you put a floor, say, of 5 percent on all the deductions, you would raise a considerable amount of revenue. My guess is at least $10 billion. I will correct the record if I am wrong. I think it is a large amount of revenue.

It certainly would be one way to go.

Mr. **Pease**. Finally, if I can, in relation to making the Tax Code more progressive, or trying to make it more progressive, I presume you would agree, Mr. Pechman, that a differential rate on capital gains would be going in the opposite direction from that point of view?

Mr. **Pechman**. Indeed. I testified last week exactly on that point.

Mr. **Pease**. OK. Let me in my remaining time turn to Dr. Heclo and say that I found your testimony to be extraordinarily direct and on point. I particularly was impressed with your statement that the real issue is one of a decent opportunity to make one's way in the world, concerning people, not their place in the income distribution, but distributing enough economic resources for purposes of buying a home and so on. I think Americans could tolerate substantial inequities in income, but I don't think they will tolerate a situation where those inequities in income occur and people at the bottom end of the scale don't have enough to live on or can't do the normal things in life.

It seems to me capitalism needs to be saved from itself. It is a productive economic system, but in the past we have tempered capitalism by using government to provide for those who are left behind, if you will.

One of the things that strikes me most of all about the last 8 years of the Reagan administration was the philosophy that what is mine is mine and what is yours is yours and the devil take the hindmost. So there was unbridled opportunity for those able to make and earn money, but not much concern for what was happening to those at the lower end of the economic scale. Every day in my congressional district I see young people who cannot make it even though both members of the family are working full time.

I want to just commend you very much for your testimony. I don't have a question of you, but I for one found your testimony splendid.

Mr. **Heclo**. Thank you very much.

Mr. **Moody**. I have a couple of questions before we finish up here.

One, let's leave government spending out of the picture for the moment. We all agree it should be cut in certain ways.

I want to examine for a minute the relationship between the deficit and national savings issue we are discussing.

If we didn't have foreign borrowing, would it really matter whether we financed government spending by borrowing or by taxes?

In other words, would the size of the deficit matter to national savings without the loophole of foreign borrowing?

If we soaked up that purchasing power out of the private economy through borrowing or through taxes, you would call one a deficit, the other you would call a balanced budget. What difference would it make to savings?

Mr. SUMMERS. If you did it through borrowing, you would raise interest rates and crowd out investments. If you did it through taxes, you would reduce people's take-home pay and reduce consumption.

Raising deficits are the anti-investment. Large deficits are the anti-investment way. Issuing bonds is anti-investment. Paying as you go by collecting taxes from households is anti-investment because it puts the burden on consumption. Even in a closed economy, there is a very substantial difference.

Mr. MOODY. Mr. Shoven, any comment?

Mr. SHOVEN. I would agree with that. You would have a big difference on national savings. In that case national savings and investment have to be the same if you are going to close the foreign borrowing window.

Mr. MOODY. You say interest rates would be higher. That, in some sense, makes savings more attractive; right? It is a reward for savings?

Mr. SUMMERS. When the supply of apples goes down, the price of apples goes up. You end up, that makes it a little more attractive to produce apples.

In the end, what you know is you are going to have less apples. Precisely the same thing when the government stops saving it receives a lot of bonds.

Think of it as the government is selling bonds. Because the government is selling bonds, the same amount of saving by households now has to go both to new capital and to holding all those government bonds. The more bonds that have to be held, that means there is less left over to loan for new investment.

Mr. MOODY. Thinking back to my public finance courses, the purpose of taxation is to suppress private consumption to avoid inflation.

Mr. SUMMERS. That is entirely consistent. Either way the government would get financed. The question is whether it will get financed out of consumption or whether it will get financed out of investment. Taxes are financing it out of consumption. Issuing bonds is financing it out of investment.

That is the——

Mr. MOODY. We still are talking consumption dollars by those bonds to some extent which make people willing to give up consumption as well.

Mr. **Summers**. When we suck dollars up by issuing bonds, the primary effect is higher interest rates. What we know is that higher interest rates cause people to give up on making investment projects at a much faster rate than they cause people to give up on consumption.

Mr. **Moody**. The efficiency of investment is altered. Yesterday John Makin testified on this topic. He suggested we simultaneously reduce the deductibility of interest costs by one-half. Only deduct half of your mortgage, for example.

He also suggested we exclude one-half of your interest earnings from your taxable income. That would make borrowing less attractive at the margin by half and make saving more attractive.

Do the four of you have any comment on that?

Mr. **Pechman**. What Makin was trying to do was to simulate the effect of indexation on capital income. But I think a 50 percent flat reduction on both sides is not the way to do it.

As John Shoven said, this is a very important deficiency of the Tax Code. We ought to do it directly by adjusting capital gains and interest for inflation, rather than by these approximations that which really don't do the trick.

Mr. **Moody**. He agreed with that. But he said the thing collapsed of its own complexity. As you know, Treasury put indexation on it.

But the complexity was so daunting it was abandoned. He is proposing this as a more workable, practical measure.

Mr. **Pechman**. I don't like the substitute. I would try to achieve some practical indexation device.

Mr. **Shoven**. I think the failure to index was a big failure of the tax reform. I actually think that this novel and simple idea is probably better than nothing. That is, I think, fit is actually what it is doing—actually what it is doing is moving part way toward the consumption tax, and a very simple way to do it.

I view it as a bit of a gimmick, but not a worthless gimmick. It certainly seems simple, and I think it would be productive.

Mr. **Moody**. I thank you.

Mr. Summers, I was startled to hear your second recommendation that we should move Social Security off-budget. What you are suggesting is in 1989 we should run a $69 billion surplus or, by the time we reduce the deficit, a $106 billion surplus.

Are you suggesting we run that kind of surplus? If we are going to run a $106 billion surplus, are payroll taxes the best way to finance that surplus? Is a surplus appropriate? Is this the way you want to finance a surplus of that dimension?

Mr. **Summers**. I think the surplus is appropriate. I think given our low level of saving that the rest of the economy is generating, it is appropriate for the public sector to generate a larger surplus.

In a broader sense, we are not running such a large surplus because the traditional account takes no account of the fact that our social security liability is increasing.

If we take proper account of the liabilities, it won't be such a large surplus.

Is it appropriate to do with the payroll tax? Personally, I think I prefer a somewhat more progressive system. I think there is a lot of appeal to the idea that we finance the Social Security system out of people's contributions under the payroll tax.

Since those liabilities are going to be going up because the generations to come are larger than the generation that is retiring now, I don't see it as inappropriate that the payroll tax would increase as a share of Federal revenues during the time when we were making that provision for the future.

I think the success of the Social Security program depends critically on the perception that the people are making contributions and then receiving benefits. If it turned into just another transfer program, it would be much more vulnerable.

Mr. MOODY. Dr. Pechman, do you have any qualms about that kind of a surplus?

Mr. PECHMAN. I have no problems with running that kind of surplus. Like Dr. Summers, I would have preferred that the financing of Social Security go the other way and that we used more progressive taxation than we did.

But the question is how do we go from here to there? How do we get the additional $200 billion to achieve that surplus? I think we ought to go to general revenues, not payroll taxation.

If you did what Larry Summers suggested, namely, move from the present $200 billion non-Social Security deficit to a balance, what you would be doing would be increasing the ratio of nonpayroll taxes to the total receipts.

Mr. MOODY. Anyone else?

Mr. SHOVEN. That kind of surplus is exactly what I was advocating.

One thing I would say about Social Security payroll taxes is I think it is too bad that we look at the system—I think I am echoing Larry here—as a tax system and a transfer system where the benefits are paid out.

I would like to see linkages between the pay-outs and pay-ins, where it does look like a pension plan from the individual's point of view. A payroll tax would be an appropriate way to contribute to your government pension.

Even if it is unfunded, it would look more like a government pension and less like a tax.

Mr. MOODY. You agree we should be running those kinds of surpluses?

Mr. SUMMERS. I might just add that if there was a desire to do something about the progressivity issue coming from the reliance on the payroll tax, I think the first thing to do would be to eliminate the payroll tax ceiling, have the upper cap which would undo a significant part of the regressivity.

Mr. MOODY. The pension would be a retirement tax?

Mr. SUMMERS. Then you would have to get involved with tax returns.

Mr. PECHMAN. I think this is important. If you included unearned income in the Social Security tax base, then the relationship between earnings and Social Security benefits would be destroyed. What Summers and Shoven are suggesting——

Mr. MOODY. It could be a flat tax on income. You agree the cap should be eliminated or phased out?

It is being raised every year.

Mr. PECHMAN. I certainly agree that the cap should be phased out, at least for the employer contribution.

Mr. MOODY. One last question. Do all of you agree that additional fraction of social security retirement income should be unsheltered? One of you proposes in your paper. Right now you have a $32,000 floor in which there is no tax, and only a half of you agree 32 percent is included in your taxable income. Current retirees receive $2, $3, and maybe $4 for every $1 they put in.

Do all of you agree we should expose more base to taxation?

Mr. PECHMAN. Yes; my father lived to the age of 90. To his dying day he insisted that he contributed every dime he got in Social Security benefits. He was furious with me when I told him he contributed only about 5 cents on the dollar.

The ratio now is 15 cents on the dollar. The contributions that the tax paid by employees to the total of the pension is now only about 15 percent.

Mr. MOODY. You put 85 percent into the base?

Mr. PECHMAN. Yes, and eliminate the thresholds. That would raise $20 billion a year. It is a real big revenue raiser.

Mr. MOODY. Any other comments on that?

Mr. SUMMERS. I would support moving in that direction. Perhaps slightly more cautiously on the reduction of the threshold than Joe.

Mr. MOODY. Thank you. It has been an excellent panel. Thank you all very much.

Congressman Tauzin, welcome to the panel. Sorry you had to catch us on a day off so we don't have full membership. Everyone will receive your testimony.

## STATEMENT OF HON. W.J. (BILLY) TAUZIN, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF LOUISIANA

Mr. TAUZIN. Let me first thank you for allowing me to visit with you on short notice like this to talk about how to increase savings incentives in America. I want to quote first from a Newsweek article on March 20, 1989.

This is an article on the Tax Code. The question is what to do about kids here. Here is a quote.

> Congress hates kids who save money. Youngsters pay more in taxes than kids that don't save a dime.
>
> If that sounds dizzy, don't complain to me. Complain to the Congressman who is supposed to represent you. Here are the rules.

They talk about a youngster who can earn up to $3,000 without paying taxes on income, nevertheless will pay a tax on whatever interest income they earn on a savings account. I have some personal experience with this.

My daughter is a first time taxpayer this year. She earned $2,700 in a part-time job in Baton Rouge where she is going to school. She also earned $60 in interest on savings from a savings account her father encouraged her to open up. When we did her taxes, we discovered she owed no taxes on the $2,700, but she owed a tax on the $60 of interest her father encouraged her to earn.

We are sending the wrong signal to youngsters and adults across America when we tell them it is good to save, and then we penalize them when they do save and earn interest. I am proposing something rather dramatic in regard to that problem.

I want to discuss it with you quickly.

This Monday, or Tuesday, rather, I filed House bill 2021. Mr. Andrews cosponsored with me on it as well as other Members of the House.

It is similar to a bill filed in 1985 where we had cosponsors that ranged from Jim Wright to Bill Dannemeyer. This is a bill that targets saving incentive at two goals. One, to do something about the awful hemorrhage that is occurring in the troubled S&L industry.

I don't have to tell you the numbers—$8 billion 1 month, 9 billion the next, 10 billion the next, hemorrhaging out of savings accounts in S&Ls.

We are having to put all kinds of taxpayer dollars behind them to rescue them. The targets saving incentive for a lower cost money. Let me tell you how it does it. The bill says in effect that taxpayers under this proposal could earn up to $5,000 of interest tax free provided they earn it in a savings account in a federally insured bank, S&L or credit union and provided they invest it in what we define as a regular passbook account.

We define it as an account that yields no more than 3 percentage points less than the T bill auction that occurs every month. Three percentage points below the T bill auction is a savings interest rate that will yield a better return to you if it is tax free than if you invest in a taxable T bill savings plan.

Why do we suggest this? No. 1, because you and I know that a 2.1-percent disposable savings rate is intolerable for an industrialized nation. We are becoming the biggest debtor nation in America.

We are borrowing funds from Japan and Germany in record numbers. We are becoming in effect hostage to those two countries lending policies. They are the Standard and Poors of America now.

If they decide our credit is no good, we are in deep trouble. It is that bad.

Second, because of what I mentioned earlier, we send out the wrong signal. I want to commend you first for the changes we made in the Tax Code that begins to send out some of the right signals.

When we begin to cut back on allowable deduction for personal interest that we accumulate on debt, we are beginning to send out the right signal. Why don't we send out the total signal and say we are not only going to stop rewarding you for accumulating personal debt, we are going to start rewarding you for saving in these federally insured accounts and we are going to encourage you to do it at these lower costs passbook accounts.

Why? Because low cost money in the S&L's, the banks, and credit unions of America has traditionally been the source for low cost mortgage money to Americans. Low cost money keeps interest rates down. You are going to ask me how much this land will cost, and I will tell you.

I will tell you what we save when we start reducing interest rates in America, when we reduce interest for mortgage holders and reduce interest for the biggest debtor in America, our own Uncle Sam.

The numbers justify what I am recommending to you.

President Bush talked about a plan something like this during his campaign. He talked about some saving incentive like this.

What we put together, I think, not only targets saving incentive correctly, but also has the effect of beginning to process, producing low cost money for our troubled thrifts and other institutions that are federally insured.

Gentlemen, I think it is time we do something dramatic like this. I think the numbers will justify it. I think Americans would love us for it, and I think we would be sending the signal to our children that we ought to be sending when I encouraged my daughter to open up a savings account and when I encourage young people all over America to do the same thing. Newsweek asked a simple question.

If all we are going to do is provide a saving incentive in retirement plans like IRA's and Keogh's, do you think any teenager is ready to tie up his little earnings in a 40-year account? I think not.

And they don't. What we need is something that encourages every teenager, every worker, every citizen of America to begin saving more and consuming less. This plan will do it.

I invite you to look at it. If it is wrong, tell me what is wrong with it. We will try to correct it.

I have had a lot of people look at it. A lot of people tell me it is time for this in America. Other countries do what I am suggesting.

In Germany, when you open up a $600 savings account, the federal government in Germany matches it on taxpayer funds for you. That is how big they created a savings incentive.

Check the laws you are creating. Look at our 2.1-percent figure and see where we are missing the boat.

Mr. Chairman, members of the committee, I will be happy to answer questions about the bill. I ask you, please, give it some thought. Look at it. A lot of people are getting interested in this now.

I think before this year is out, we will have more than 100 cosponsors to show you a range of interest from the most conservative to the most liberal among us because this is a plan all Americans can share in.

Thank you.

[The statement of Mr. Tauzin follows:]

TESTIMONY OF THE HONORABLE
W. J. (BILLY) TAUZIN
BEFORE THE COMMITTEE ON WAYS AND MEANS
APRIL 20, 1989

In support of H.R. 2021, the "Save, America Act of 1989", as a way to increase American savings.

Before I begin my formal testimony let me take this opportunity to thank Chairman Rostenkowski and the other members of the Ways and Means Committee for allowing me to come before you on such short notice to share some of my thoughts on the important issue of encouraging savings in the United States.

Until this point in the hearings you have heard mainly about IRA's and other long term investment ideas. I seek a different approach. On April 18th, the day after the federal income tax filing deadline, I introduced legislation to address the festering problems facing the Savings & Loan industry and the nation's savings rate. The Save, America Act of 1989 proposes something unique to current legislation, the Save America Act gives Americans an INCENTIVE TO SAVE and encourages the infusion of private funds into our troubled federally insured savings institutions.

The bill we have introduced, H.B. 2021, will allow **EVERY TAX-PAYING AMERICAN** THE RIGHT TO EARN UP TO $5,000 PER YEAR IN TAX-FREE INTEREST EARNINGS ON SAVINGS ACCOUNTS IN FEDERALLY INSURED BANKS, SAVINGS AND LOANS, AND CREDIT UNIONS, with NO restrictions on how they dispose of those earnings.

By defining "qualified institution" as a federally insured institution, the Save, America Act of 1989 purposefully targets the incentive in order to particularly address hemorrhaging institutions covered under FSLIC. Today, investors flee these institutions, taking what struggling savings & loans need most- individual savers. The more private money brought into these accounts, the fewer federal dollars eventually need go out for their rescue. While no panacea for the Bailout sickness, the Save, America Act should provide a solid capital base for these federally insured financial institutions.

Addressing the mechanics of this bill, we provide a ceiling on these accounts' interest rates at 3 percentage points below the T-bill auction rate so as not to interfere with other government obligations. This may allow for a decline in overall interest rates by providing less expensive capital for institutions to invest in our communities for home building and smaller business growth. As we all know, that kind of economic growth pays big dividends to the U.S. Treasury. The prevailing trend in national savings rate- the difference between the nation's output in goods and services and what is consumed by government and individuals- since the mid 1970's has been disastrous, dropping from 7.9 percent to the 1985-87 rate of 2.1 percent. This disturbing fall increases the risk of recession and ultimately adversely affects growth in the standard of living.

Rising savings rates translate into more U.S. capital for investment, and resulting lower interest rates are good news for those with big debt. Know anybody with a whopping big debt? You guessed it! Our own best uncle, UNCLE SAM. Finally, linking the interest rates with the T-bill rate will make this account concept more sensitive to the marketplace and less susceptible to inflation. Can you think of anything more attractive to the individual saver?

Recently, we have heard debate over a capital gains tax exemption. Granting a more generous capital gains tax break may help some Americans and may spur some investment, but what about a plan giving all tax-paying Americans a chance to save for their future. The Save, America Act will help out the little guy and may motivate the general public to even greater investment- Who knows? We might even see the resurgence of payroll savings plans!

On March 20, 1989, Newsweek magazine ran a story on saving money in the United States. The opening line read "Congress hates kids who save money". It briefly outlined the tax policy which penalizes kids for putting money into savings accounts rather than spending their earnings. I have some personal experience in this area. My daughter, Kristie, filed her first income tax forms this past year. In doing so she discovered that she owed federal taxes on the money that her father encouraged her to place in a savings account. Her level of earning for the year was such that she owed no income tax, but now Kristie must pay taxes on the $60 that she earned on her savings.

The importance of this example lies in the "big picture". My daughter and other young people are encouraged to save money, but when they do save we subject them to taxation. Such an inconsistency projects an unhealthy example to all citizens. In a society that pressures its young people to consume, we need to encourage them to save... taxing their saving's interest is not the proper message to send.

Current law generally taxes interest earned on savings accounts. Your hearings ask crucial questions which must be addressed for the economic health of the United States. Why do we tax people for doing what is fiscally responsible? Why do we discourage citizens from saving for their future? This legislation encourages citizens to save without penalty while retaining liquidity. Best of all, this plan would, for the first time, send out the right message to the American people: "We'll stop penalizing you for saving; we'll reward you, instead."

Mr. **Moody**. Thank you.

Congressman Andrews.

Mr. **Andrews**. Thank you, Mr. Chairman.

Only to say I think this is a good idea. I really endorse what our colleague is trying to emphasize. That is to increase savings in this country, especially to give incentive to some of the small wage earners in the country to save.

I am curious, though. This is a time of tight budget constraints. This committee is going to be asked to make some fairly hard choices to try to meet the Gramm-Rudman targets. Tell us what your thoughts are about what revenue impact would be.

What is the loss going to be to the Treasury to initiate this program?

Mr. **Tauzin**. I am going to give it to you straight. CBO estimated in 1985 when we proposed a similar idea that was not targeted at federally insured accounts, that, too, cost the Treasury about $2.5 billion the first year.

But consider, if you will, that we are targeting low cost money in the economy. If it has a desired effect, as many people have looked at it tell me it will have, and that is moderating and reducing interest rates, a 1-percent reduction to the Federal Government saves us, according to CBO, $9 to $10 billion.

A 1-percent reduction in home mortgage rates will increase the Treasury's take of the expanded economy in this area by $13 to $23 billion. This is CBO numbers. And will increase savings for individuals on their mortgage payments to about $30 billion.

It is about a 10-to-1 return when you look at Federal Treasury dollars—10-to-1 return.

And we can do something awful good for America at the same time.

Mr. **Andrews**. Thank you, Mr. Chairman.

Mr. **Moody**. Thank you.

Mr. McGrath.

Mr. **McGrath**. Thank you, Mr. Chairman.

Thanks, Billy, for your testimony and for presenting this bill to us. I am just wondering, is this applicable to just federally insured banks, or do you think perhaps it has advantages for other investment instruments that perhaps some of our constituents would prefer to use?

Mr. **Tauzin**. No question it does. We proposed a plan originally without this targeting. I think in this year when we are watching taxpayer dollars bail out the federally insured accounts, we set up, it makes better sense for us to target these incentive programs where taxpayer dollars are at risk. I am asking you to surrender 2.5 billion of taxpayer dollars to make this plan work.

I am suggesting to you that the infusion of private funds into these troubled S&Ls under a plan like this would make better sense for our taxpayers than the kind of taxpayer bailout we are about to go through.

It makes sense to target it.

Mr. **McGrath**. Do you have any handle on the revenue we might lose if we expanded it to other savings instruments?

Mr. **Tauzin**. I didn't hear the last part of the question.

Mr. McGrath. If we expanded the idea to other savings instruments, what would the revenue hemorrhage be?

Mr. Tauzin. The $2.5-billion figure I gave you was a 1985 CBO estimate for all institutions, not just federally insured. So that I assume if we targetted, as we suggest this year, we would narrow the $2.5 billion.

Mr. McGrath. You would narrow the application?

Mr. Tauzin. Yes.

Mr. McGrath. Thank you so much.

Mr. Moody. Thank you very much.

Mr. Pease.

Mr. Pease. Thanks very much to our colleagues for an interesting idea and an outstanding presentation this morning. I might make one suggestion to you that will make your daughter feel better about her savings account.

Was the $27 on interest?

Mr. Tauzin. About $60.

Mr. Pease. Why don't you tell her that she is not paying any taxes at all on the interest, but she is paying $60 of tax on the latter part of—was it $80 of interest?

Mr. Tauzin. She paid about $12 tax.

Mr. Pease. Tell her there is no tax on the interest and she is paying $12 tax on the last $60 of the $2,700 that she earned.

Mr. Tauzin. The problem on that is she was not born yesterday. She is 18 now. She is at LSU, too. You know she is sharp.

She knows the student next to her who earned $2,700 and spent it all didn't pay a dime in taxes. She knows because she did what I encouraged her to do, she ended up with a tax liability.

She did earn interest and came out a little ahead. The point I am making is I gave her one signal as a parent. I said, save. Don't spend all your money, Cristy. You are going to need it down the line. She followed my advice. She said, wait. The Federal Government in a sense is going to penalize me for doing what Dad told me to do. I said, you are right. Newsweek pointed it out again.

What I am saying if we are sending that wrong signal to our children, we are sending that wrong signal to all of America. We ought to think about reversing it in a way that really builds up savings accounts without the limitations we put on IRA's and Keogh's.

While they are good and directed at solving a problem of building retirement accounts in lieu of everybody relying on Social Security as the sole retirement, that is a good move. They also froze a lot of that money out of what people might do with it, which is put down payments on mortgages or educate their children.

I am suggesting we let people make good choices after that as to where they want to use that interest we allowed them to earn as a reward for saving.

Mr. Pease. That is a good point. You tell me your daughter was not impressed when you told her she was $48 net better off than her friend who earned the same amount of money?

Mr. Tauzin. No, because her friends enjoyed spending that other $60.

Mr. Pease. Unfortunately, that is a common reaction among teenagers.

Mr. TAUZIN. The whole country is on a consumption binge. We all love those Sony's. We want everything everybody is making and we are not making enough money anymore. If we encourage the formation of private capital in our banks and S&L's and credit unions instead of encouraging this consumption binge, we might do a lot to reverse that trend. We might instead begin to build up accounts here to fund our deficits, personal and governmental, rather than having to borrow from the Japanese and Germans all the time.

Mr. PEASE. Thanks a lot.

Mr. MOODY. Thank you very much.

Congressman Levine.

## STATEMENT OF HON. MEL LEVINE, A REPRESENTATIVE IN CONGRESS FROM THE STATE OF CALIFORNIA

Mr. LEVINE. Thank you for giving me the opportunity to testify at these hearings. I would like to begin both by complimenting the chairman of the full committee and the entire committee for their leadership in holding these hearings on improving the national savings rate. I do have a fairly extensive statement that I would like to ask unanimous consent to be included in the record, and I would like to read certain parts of it.

Mr. MOODY. Without objection, it will be.

Mr. LEVINE. Mr. Chairman, the time has come for all of us to demand that the Bush administration show the type of leadership that this committee is showing in restoring the Nation's competitiveness. At a time when America has become the world's largest debtor and our budget and trade deficits remain sky high, increasing the savings rate is an absolutely urgent national priority.

If the President does not act more firmly, low savings in investment could cause years of decline in the nineties and beyond. As some of the members of this committee may know, I cofounded Rebuild America, a nonprofit organization whose Board includes Dr. George Hatsopoulos, who testified here yesterday, and whose Leadership Council is chaired by Robert Solow, winner of the Nobel prize in economics. Rebuild America recently published a white paper called "An Investment Economics for the Year 2000," which was by Dr. Solow, Lawrence Chimerine, Pat Choate, Paul Krugman, Robert Reich, Lester Thurow, and Laura Tyson.

The white paper makes a strong case for raising America's saving rate, and I would like to submit it for the record today. Rebuild America has also prepared a background memo on America's historical use of low-denomination bonds and examples of targeted investment, entitled "U.S. Savings Bonds and Investment Trust Funds," which I wish also to submit for the record.

My testimony here today focuses on three main points:

First, America's low national savings will imperil our Nation in the decade ahead unless remedied;

Second, America should not just raise savings, but we should set the great national goal of matching our top competitors' savings rates by the year 2000; and

Third, the key to raising national savings is to launch a campaign tying it to investment—Americans will support policies to raise national savings if assured that their deferred consumption will be invested wisely.

My major concern, however, is this: The Reagan and Bush administrations have been gambling with America's future, and with our children's future. It is the height of irresponsibility to accumulate debts which our children may have to spend a whole lifetime to repay.

No nation in history has borrowed and consumed its way to greatness, and the President and the Congress must show more leadership in raising savings and investment if we are to leave a legacy of which we can be proud for our children.

We need far bolder leadership from President Bush than we have seen to date. The short-sighted policies of the Reagan and Bush administrations have placed America in peril, and they must be reversed.

The United States has seen its savings rate fall to a postwar low in recent years, and we now possess the lowest savings rate of our top competitors.

Our unprecedented peacetime borrowing—by individuals, business and governments—in the past 6 years has thus far masked the consequences of our drop in national savings. The United States has gone from having a positive net international investment position of $130 billion in December 1982, to an estimated international deficit of $450 billion today: a shift of $580 billion in just over 6 years—$9,600 for every family of four in the United States.

The problem of low national savings, moreover, is aggravated by the problem of low national investment.

Our borrowings in the 1980's, however, have been used largely for consumption rather than investment.

I do not need to tell you what this explosive mixture of low savings, high foreign debt and low investment means: it spells trouble.

Mr. Chairman, America needs both a bold national savings goal and a commonsense approach to meeting it.

The economists at Rebuild America have concluded that:

If America is both to invest more and rely upon foreigners less, it will need to save more. The United States should seek to raise net national savings by at least 1 percent of GNP annually between 1989 and 2000, to ensure that we at least match the 11-percent levels enjoyed by our top competitors.

This 11-percent figure is the average net savings rate of Great Britain, France, West Germany, Italy, and Japan in 1986. It is midway between America's 2-percent net savings rate in 1986 and Japan's 17.3 percent in the same year.

Setting a goal of 10 to 12 percent national savings by the year 2000 seems to us an ambitious but realizable goal.

Although deficit reduction and changes in the Tax Code are desirable, it does not appear that these steps by themselves will raise national savings sufficiently over the next decade.

Although we should consider changing the 1986 Tax Code, and cut the deficit to significantly raise national savings, we must also do more. The basic fact is that the American people will need to be convinced to raise savings. This will require the kind of national campaign waged in the 1940's and 1950's to promote savings.

I believe that Congress, the President, and business should begin planning such a campaign to increase U.S. savings in the 1990's. The campaign would focus on increasing savings through the sales of bonds. But in so doing, it might also educate the public about the need for savings and thus build political support for changes in the Tax Code and deficit reduction that would also increase national savings.

We are all greatly indebted to Dr. Hatsopoulos for the important work he is doing by not only demonstrating the need for greater savings, but also by suggesting positive ways to accomplish this.

I strongly support his proposal for supersaver bonds—and agree with him that they should feature regular payroll deductions and incentives to hold them for 7 years. And I agree that they should be marked through a national campaign.

I would also like to stress one other basic principle critical to the success of a campaign to increase national savings: the need to tie proposals for increasing savings to productive investments as closely as possible.

I have begun to study ways that one could design investment bonds as well as savings bonds. The proceeds from investment bonds would be targeted to goals like promoting private sector research and development or efforts to commercialize the new technologies of the future. While it is too early to unveil any concrete proposals, I hope this committee will begin looking at ways to link proposals to raise national savings more closely to investment.

Mr. Chairman, the American people have always responded to calls to revitalize this Nation—from World War II to the space program to the energy crisis.

I congratulate this committee and its chairman for holding these hearings—it is an example of the kind of political leadership we will need in the 1990's. It is time for us to demand the same kind of leadership from the White House. Thank you.

[The statement and attachments of Mr. Levine follow:]

## Testimony on Savings and Investment
by
Congressman Mel Levine

I would like to compliment the chairman and the committee for their leadership in holding these hearings on improving the national savings rate. The time has come for all of us to demand that the Bush Administration show similar leadership in restoring this nation's competitiveness. At a time when we are the world's largest debtor, and our budget and trade deficits remain sky-high, increasing the savings rate is an urgent national priority. If the President does not act more firmly, low savings and investment could cause years of decline in the 1990's and beyond.

As the Chairman may know, I co-founded Rebuild America, a non profit organization whose Board includes Dr. George Hatsopoulos, who testified here yesterday, and whose Leadership Council is chaired by Robert Solow, winner of the Nobel Prize in economics. Rebuild America recently published a White Paper called "An investment Economics for the Year 2000", which was co-authored by Dr. Solow, Lawrence Chimerine, Pat Choate, Paul Krugman, Robert Reich, Lester Thurow and Laura Tyson.

The white Paper makes a strong case for raising America's saving rate, and I would like to submit it for the record today. Rebuild America has also prepared a background memo on America's historical use of low-denomination bonds and examples of targeted investment, entitled "U.S. Savings Bonds and Investment Trust Funds", which I wish also to submit for the record.

My testimony here today focuses on three main points:

(1) America's low national savings will imperil our nation in the decade ahead unless remedied;

(2) America should not just raise savings, but set the great national goal of matching our top competitors' savings rates by the year 2000; and

(3) the key to raising national savings is to launch a campaign tying it to investment--Americans will support policies to raise national savings if assured that their deferred consumption will be invested wisely.

My major concern however, is this: the Reagan and Bush Administrations have been gambling with America's future, and with our children's future. It is the height of irresponsibility to accumulate debts which our children may have to spend a whole lifetime to repay. No nation in history has borrowed and consumed its way to greatness, and the President and the Congress must show more leadership in raising savings and investment if we are to leave a legacy of which we can be proud for our children.

We need far bolder leadership from President Bush than we have seen to date. The short-sighted policies of the Reagan and Bush Administrations have placed America in peril, and they must be reversed.

### Low National Savings Imperil Our Future

National savings are a critical component of economic growth. While economists may argue about the most desirable savings rate, there is general agreement that healthy savings lead to a healthy economy. Savings for a nation, as for an individual, are needed to finance investments and provide a cushion for hard times,

It is therefore a matter of some concern that the United States has seen its savings rate fall to a post-war low in recent years, and that we possess the lowest savings rate of our top competitors. Net national savings stood at 2.8% at the end of 1988, less than half the 7.9% average savings in the 1960s. Our 2% net savings rate in 1986 was less than one-eighth Japan's 17.3% and one-fifth the 10.8% average of France, Italy, Germany, Great Britain and Japan.

Our unprecedented peacetime borrowing -- by individuals, business and governments -- in the past 6 years has thus far masked the consequences of our drop in national savings. The United States has gone from having a positive net international investment position of $130 billion in December 1982, to an estimated international deficit of $450 billion today: a shift of $580 billion in just over 6 years -- $9600 for every family of four in the United States. This extraordinary inflow of foreign funds -- without peacetime precedent in history -- has substituted for the national savings that would normally be needed to fund investment and government spending.

The problem of low national savings, moreover, is aggravated by the problem of low national investment. As many have noted, high foreign borrowings are not necessarily a problem, if they are invested wisely. America built its railroads by borrowing money from foreigners, but this was an investment that was repaid handsomely many times over.

Our borrowings in the 1980's, however, have been used largely for consumption rather than investment. We have been steadily increasing the share of national output consumed, from an average of 58% in the 1950s to 65% in 1988. On a net basis, U.S. investment performance has declined significantly -- averaging over 2.3% in the 1980s vs. 3.3% in the 1970s and 3.5% in the 1960s.

Mr. Chairman, I do not need to tell you what this explosive mixture of low savings, high foreign debt and low investment means: it spells trouble.

Foreigners will not keep pouring money in here indefinitely at the rate of the past 6 years. And when they stop lending to us, and/or our economy slows down in coming years, we could face the most serious recession of the post-war era - or something even worse.

We must ask ourselves, for example, what would happen should a recession begin in the next several years? The budget deficit will balloon, and aggravated international debt crisis will threaten the health of our banks, and many American businesses will find themselves unable to service their debts. Do we really think that foreigners will lend us sufficient funds to service their debts. Do we really think that foreigners will lend us sufficient funds to meet all of these needs? And if not, what can we do now to prepare for this eventuality?

The place to start is by raising the national savings rate. If we have higher national savings, we will have a sufficient surplus to get us through coming hard times. If we do not, millions of Americans could suffer a dramatic cutback in their living standards.

As the Chairman has wisely noted in the press release announcing these hearings, the solution to this problem will necessarily be long-term. We cannot reverse the national savings problem overnight.

But while this effort requires long-term effort, it must begin immediately. We must not allow the Bush Administration to put off finding a solution to our savings and investment problems the way the Reagan Administration delayed dealing with the savings and loan crisis. For as we discovered in the S&L case, such problems deferred do not disappear. In fact, they simply grow worse and cost far more to remedy when eventually confronted.

## Matching Our Top Competitors' Savings Rate By the Year 2000

Mr. Chairman, America needs both a bold national savings goal and a common sense approach to meeting it.

The economists at Rebuild America concluded that:

If America is both to invest more and rely upon foreigners less, it will need to save more. The United States should seek to raise net national savings by at least 1% of GNP annually between 1989 and 2000, to ensure that we at least match the 11% levels enjoyed by our top competitors.

This 11% figure is the average net savings rate of Great Britain, France, West Germany, Italy and Japan in 1986. It is midway between America's 2.0% net savings rate in 1986 and Japan's 17.3% in the same year.

Setting a goal of 10-12% national savings by the year 2000 seems to us an ambitious but realizable goal.

It is difficult to imagine how we can match our top competitors' economic performance in the 1990s if we do not match their savings. We could in the past maintain somewhat lower national savings than they because we led in manufacturing and technological innovation, and possessed vast national savings- still $130 billion as late as 1982, as noted above.

Now, however, they are making a concerted effort to surpass us technologically, and our high national debt is impeding our efforts to keep our lead. We must raise national savings steadily but dramatically if we wish to match our top competitors' economic performance in the year 2000.

## Launching a Savings and Investment Campaigns

Although deficit reduction and changes in the tax code are desirable, it does not appear that these steps by themselves will raise national savings sufficiently over the next decade.

For underlying America's economic problems today are its political ones. Americans do not support paying higher taxes for general deficit reduction. We therefore cannot rely on deficit reduction alone to raise the savings rate.

And there is also understandable reluctance to tamper with the 1986 tax code, because of the fear that letting in some changes will invite wholesale tampering with it.

Although we should consider changing the 1986 tax code, and cut the deficit to significantly raise national savings, we must also do more. The basic fact is that the American people will need to be convinced to raise savings. This will require the kind of national campaign waged in the 1940s and 1950s to promote savings.

The background paper submitted to this hearing recalls the history of the U.S. Savings Bond program. It notes, for example, that not only had 80% of all American adults purchased war bonds or stamps during World War II, and that 6 million Americans had participated in selling war bonds, but that the savings bond campaign continued well into the 1950s, and indeed to this day.

Mr. Chairman, this experience demonstrates it is possible to raise the national savings rate through a concerted campaign in peacetime.

I believe that Congress, the President and business should begin planning such a campaign to increase U.S. savings in the 1990s. The campaign would focus on increasing savings through the sales of bonds. But in so doing, it might also educate the public about the need for savings and thus build political support for changes in the tax code and deficit reduction that would also increase national savings.

We are all greatly indebted to Dr. Hatsopoulos for the important work he is doing not only to demonstrate the need for greater savings, but to suggest positive ways to accomplish this.

I strongly support his proposal for "Super-Saver" bonds - and agree with him that they should feature regular regular payroll deductions and incentives to hold them for seven years. And I agree that they should be marked through a national campaign.

I would also like to stress one other basic principle critical to the success of a campaign to increase national savings: the need to tie proposals for increasing savings to productive investments as closely as possible.

I have begun to study ways that one could design "investment bonds" as well as "savings bonds." The proceeds from "investment bonds" would be targeted to goals like promoting private sector research and development or efforts to commercialize the new technologies of the future. While it is too early to unveil any concrete proposals, I hope this Committee will begin looking at ways to link proposals to raise national savings more closely to investment.

Mr. Chairman, the American people have always responded to calls to revitalize this nation - from World War II to the space program to the energy crisis.

I congratulate this committee and its Chairman for holding these hearings- it is an example of the kind of political leadership we will need in the 1990s. It is time for us to demand the same kind of leadership from the White House. Thank You.

# AN "INVESTMENT ECONOMICS" FOR THE YEAR 2000

## A White Paper on America's Future

### THE COMMITTEE ON AMERICA'S FUTURE, REBUILD AMERICA

Lawrence Chimerine, The WEFA Group
Pat Choate, TRW
Paul Krugman, MIT
Robert Reich, Harvard
Robert Solow, MIT - Chair
Lester Thurow, MIT
Laura Tyson, U.C. Berkeley

### REBUILD AMERICA

Mel Levine, National Co-Chair
Mark Dayton, National Co-Chair

# AN "INVESTMENT ECONOMICS" FOR THE YEAR 2000

## A White Paper On America's Future

### Authors

**Lawrence Chimerine**, Chairman and CEO of the WEFA Group, a consulting firm formed by the merger of Chase Econometrics and Wharton Econometrics. He advises clients in the corporate, government, and financial sectors.

**Pat Choate,** Vice-President, Office of Policy Analysis, TRW Inc. He is the author of *The High-Flex Society,* and a public policy specialist whose proposals for rebuilding America's infrastructure and financing the training of American workers have received particular attention.

**Paul Krugman**, Professor of International Economics at MIT. His work has focused on examining trade policy in industries characterized by dynamic scale economies and imperfect competition.

**Robert Reich,** Professor at the Kennedy School of Government at Harvard University. He has written widely on the need for new public-private strategies to promote America's economic growth, and is the author of *Tales of a New America.*

**Robert Solow, Chair,** Institute Professor of Economics at MIT, and recipient of the 1987 Nobel Prize for Economics. He was honored for his work demonstrating that technological innovation is a key component of economic growth.

**Lester Thurow**, Dean of the Sloan School of Management, MIT. He is the author of *The Zero-Sum Solution,* a book proposing a comprehensive set of macro and microeconomic policies designed to revitalize the American economy.

**Laura Tyson,** Professor of Economics at the University of California, Berkeley, and Director of Research at the Berkeley Roundtable on the International Economy. Her work has focused on competitiveness and the economies of Eastern Europe.

* * *

The authors are particularly grateful to **Dr. George Hatsopoulos,** Chairman and Chief Executive Officer of Thermo Electron Corporation of Waltham, Massachusetts, who made significant contributions to this paper.

**NB. This document has been prepared by the Committee on America's Future, and solely reflects the views of the authors.**

*"An attempt to continue the debt-financed consumption of the last eight years for another decade risks reducing the United States to a second-rate economic power like Great Britain, Spain, and France before us. It is wrong to gamble the future of a nation on accomplishing a feat which no great power in history has achieved.*

*"But if America seeks gradually and carefully to shift its resources from consumption to productive investment between now and the year 2000, we can both prevent national decline and help usher in a new era of domestic and global prosperity."*

*-- From "An 'Investment Economics' for the Year 2000"*

# AN "INVESTMENT ECONOMICS" FOR THE YEAR 2000

## Precis

**America today needs a national investment strategy - not merely a "policy agenda" - to ensure living standards as high as any other nation's in the year 2000. Our key challenge is to move from a high-consumption to high-investment society in a way that is not regressive. Such a strategy would:**

## I. SET LONG-TERM NATIONAL GOALS

The next President should mobilize America around a national goal for the year 2000 of meeting such *quantitative* targets as matching Japan's 23% plant and equipment investment rate, its 2.8% share of GNP devoted to civilian R&D, and the 11% average net savings rate of our top competitors. Similar long-term goals should be set for *private investment* in training, research, marketing and distribution, and *public investment* in education, training, technology and infrastructure.

The President should also set *qualitative* goals of developing a more **productive** America in which corporate managers think long-term and teaching is a more highly regarded profession, and a **fairer** America marked by greater workplace democracy and employment security. Priorities would be placed on *investment in people* to improve America's workforce, and restoring the principle of fairness to economic policy-making.

## II. MEET INTERIM OBJECTIVES

Annual benchmarks should be established to measure our progress toward U.S. long-term goals. America should seek, for example, to have GNP growth exceed consumption growth by 1% of GNP annually. The difference should be devoted to increasing productive investment and reducing the trade deficit. Such a policy would have yielded $62.7 billion more real plant and equipment investment than actually occurred between 1985 and 1987.

A National Investment Commission should also seek to establish other interim benchmarks, such as progress towards producing civilian engineers, attracting excellent young people to the teaching profession, and reducing illiteracy and the school dropout rate.

## III. IMPLEMENT POLICIES SUFFICIENT TO ACHIEVE NATIONAL GOALS

Proposed policies should be sufficient to achieve national goals, not simply boost "investment" by an arbitrary amount. Needed policies include **investment-oriented deficit reduction** of some $40 billion annually, assuming our allies expand their economies by a similar amount and the absence of a recession; effective **savings incentives**; efforts to **remove Social Security from the unified budget**; incentives for **increased private investment** such as effective investment tax credits and reduced capital gains for long-term holdings; and policies to promote **global growth**, including efforts to boost Third World purchasing power.

# AN "INVESTMENT ECONOMICS" FOR THE YEAR 2000

## Contents

**Precis**
**Foreword** i
**I. Introduction: Investment-led Growth and the Year 2000** 1
**II. Investment Economics: Towards a New Consensus** 11
**III. Investment Economics: The Need** 14
    Living standards
    Productivity
    Capital
    Labor
    Technology
**IV. Investment Economics: Goals for the Year 2000** 23
    Assigning a Priority to Domestic Investment
    Long-term Quantitative Goals
    Interim Quantitative Objectives
    Qualitative Goals and Objectives
**V. Investment Economics: Policies for the Year 2000** 32
    Reduce the Federal deficit
    Provide savings tax incentives
    Remove Social Security from the unified budget
    Increase investment in modernization and infrastructure
    Increase investment in people
    Promote global growth
**VI. Conclusion: Investment Economics - The Prudent Course** 41

**Appendix A:** U.S. Productive Investment
**Appendix B:** Actual vs. "Investment Economics" Performance
**Appendix C:** Historical U.S. Savings and Investment Data

# AN "INVESTMENT ECONOMICS" FOR THE YEAR 2000

## A White Paper On America's Future

## FOREWORD

by Representative Mel Levine and Mark Dayton
National Co-chairs, Rebuild America

This White Paper, authored by some of America's most distinguished economists, advocates a trail-blazing new direction for U.S. economic policy. Although most economists agree that productive investment is the key to rising living standards, America has prospered for 40 years now without setting clear goals for productive investment. Instead, policy-makers have argued that maintaining high levels of demand (the Keynesian approach) or cutting marginal tax rates (supply-side economics) will automatically translate into the higher investment needed to ensure rising living standards in the years to come.

Today, however, amidst falling net investment in plant and equipment and increasing dependence on the vagaries of foreign investment, we can no longer rely on these older approaches. We need, for the first time in post-war history, a strategy that sets *explicit* investment goals that equal the performance levels of our top competitors by the year 2000.

Called "investment economics," this strategy would seek to mobilize the private and public sectors to increase investment in plant and equipment, R&D, education, training and infrastructure. Over the long run, we must match our rivals' investment to match their living standards.

Our economy has been so strong for so long that we tend to take basics like savings and investment for granted. During the past eight years, however, savings have fallen dramatically, we have amassed the world's largest debt for consumption rather than investment, and an alarming "investment gap" has opened with our top competitors.

As a result, we face a contradiction between our economy's present performance and future prospects. The debt-driven consumption which is producing satisfactory employment, growth and inflation today may contribute to low growth, high inflation and rising unemployment tomorrow. Inadequate investment could see us lose our lead in manufacturing innovation for the first time since Henry Ford invented the assembly line, further erode our already deteriorating physical infrastructure, and continue to fall behind in the education and training of our people.

It is certainly not too late to reverse course. We can celebrate the millennium as a world-class economic power offering rising living standards to ourselves and our children. To do so, however, we will need the kind of bold strategic thinking presented in this White Paper. Past Administrations have often promoted "agendas" listing initiatives unrelated to overall national goals. Our next President needs to develop a comprehensive investment *strategy* - of long-term goals, interim objectives, and goal-related policies.

Such a strategy is not only economically desirable but politically necessary. Experience suggests that Americans cannot be mobilized around "austerity" policies focused primarily on deficit reduction. However, they will support policies designed to boost productive investment, and will defer present consumption for future gain if convinced that investment strategies are both effective and fair.

The strategy proposed by the White Paper is noteworthy for its focus on :

**(1) Investment as a Policy Guide** - The report calls for making productive investment the key criterion for future economic policy. Neither deficit reduction nor tax reform should be seen as ends in and of themselves - as is currently the case. Rather, proposed initiatives would be evaluated by the extent to which they increase productive investment. One would not cut education in reducing the deficit, for example. Nor would one preclude reducing taxes for commercial R&D or long-term capital investment in the name of tax reform.

**(2) Measurable Goals** - The study is the first to call for measurable goals - both quantitative and qualitative - that match our top competitors' savings and productive investment performance by the year 2000, so that we can match their rise in living standards.

**(3) Macroeconomic *and* microeconomic policy** - The report calls for policy-makers to unite on the need for both macro and microeconomic policies to restore productive investment, rather than to continue to focus on such older debates as the proper role for government in the economy.

**(4) The need for long-term solutions** - This study states categorically that "there are no short-term solutions" to America's economic policy. Instead, it suggests, the next President should commit America to a gradual "investment buildup" for at least the next decade.

The report is also noteworthy because its authors, who in the past have had different viewpoints on such questions as the appropriate role of government, have reached agreement on the critical importance of promoting productive investment. **Rebuild America** is honored that these economists have joined its Committee on America's Future, and looks forward to developing concrete policies to implement the vision presented in this White Paper.

We believe strongly that Americans will respond to calls to invest in America's future and that our nation's best days are yet to come. We hope that this White Paper will contribute to the great national debate needed on restoring the foundations of our economic strength.

# AN "INVESTMENT ECONOMICS" FOR THE YEAR 2000

## A White Paper on America's Future

## I. INTRODUCTION: INVESTMENT-LED GROWTH AND THE YEAR 2000

The time has come to lift our sights from today's short-term concerns to the new millennium. This nation should set ambitious new investment *goals* for the year 2000 to maintain U.S. living standards and influence. To achieve them, we must implement a *strategy* for investment-led growth that matches the capital, labor and technology performance of our top competitors.

***The next President should seek to mobilize the nation around a comprehensive investment strategy, rather than "austerity" through deficit reduction.***

The United States still has ample inherent advantages - considerable natural resources, political stability, a unified internal market, and a highly flexible and innovating society - that should ensure it a living standard the equal of any in the world for the indefinite future.

By amassing the world's largest debt for consumption rather than investment, however, we have jeopardized many of these advantages.

The recent national economic debate has focused on such *short-term* issues as the quantity and quality of jobs created over the past decade, or the meaning of continued growth in 1988 despite the October 1987 stock market crash.

Of far greater consequence, however, are the *long-term* implications of present policy. America's recent drop in national savings and domestically generated productive investment is without post-war precedent. If current trends continue into the 1990s, America could at best face a Great Britain-like scenario of generations of gradual decline in relative living standards and national influence. At worst, our present path could provoke a financial crisis and dramatic reduction in domestic and global well-being.[1]

New policies are clearly needed - built around a national investment strategy that sets concrete, achievable goals for restoring the process of savings and productive investment.

Such an approach would focus above all on providing *direct* incentives and initiatives for productive investment. "Supply-side" policies for increasing investment *indirectly* by reducing taxes on upper-income Americans have not succeeded. And older indirect approaches, such as seeking to boost investment by increasing consumption, are today more likely to increase imports than domestic production.

We need instead a third way: a strategy for "investment-led" growth comprising three key elements: (a) **investment-oriented deficit reduction** that restores savings and reduces debt - through spending cuts and/or revenue increases that do not impair productive investment; (b) incentives for productive **private sector** investment; and (c) increased productive **public sector** investment.

The next President should mobilize the nation around such a comprehensive investment strategy, rather than "austerity" through deficit reduction. During the past decade, millions of Americans supported investment-oriented policies at the state level, even as they failed to rally to the cause of balancing the Federal budget.[2] Americans are unlikely to embrace meeting the fiscal shortfall in the 1990s unless it is closely tied to such concrete achievements as better schools, factories or jobs.

***America could at best face a Great Britain-like scenario of generations of gradual decline in relative living standards and national influence.***

And while significant deficit reduction is important, the economy will only benefit if the amounts saved are directed toward productive uses. Our biggest problem today is not the absolute size of the debt, but the fact that it has been used for consumption rather than productive investment. Deficit reduction should be seen as an element of a grand strategy that *invests our way out of debt,* rather than as an end in itself.

But if America should not embrace austerity, neither can it continue excessive consumption. With the net national savings rate at only 2%, net foreign borrowing approaching $500 billion, and a trade deficit standing at more than $100 billion for years to come, America cannot continue indefinitely to consume more than it produces. Action is needed to restore national savings through an "investment-led" growth strategy that includes significant trade and budget deficit reduction.

In addition to emphasizing investment over either austerity or consumption, moreover, the next President needs to restore the principle of *fairness* to economic policy-making. Although all Americans must participate to generate the investment levels required, the public will only support such a strategy if those at the top are seen to pay their fair share.

America's overall challenge for the 1990s is thus to **shift from a high-consumption to high-investment society in a way that is not regressive.**[3] Eight years ago we looked backwards, asking whether we were better off in 1980 than we had been in 1976. Today we need to look forward, asking whether we will actually be better off in the year 2000 than we are today.[4]

The idea of setting goals and mobilizing for them is not new to America. It is how we combatted the Depression, won the Second World War, won the space race in the 1960s, and solved the energy crisis in the 1970s. We must now apply these traditions to the coming decade. If the 1950s, 1960s and 1970s were "decades of spending," and the 1980s a "decade of debt," the time has come to make the 1990s a "decade of investment."

America's ambitious domestic agenda today includes not only improving the economy and living standards, but seeking to end poverty and homelessness, renew the environment, combat drug addiction, provide adequate health and senior care, resurrect the space program, meet our international responsibilities, and maintain an adequate defense.

It is unclear at this point whether America can afford this agenda. The space station is estimated to cost $30 billion, for example.[5] It is conservatively estimated that it will cost $100 billion to clean up the nation's hazardous waste sites.[6] $35-50 billion is needed to bail out the nation's ailing savings and loans.[7] Repairing the nation's aging nuclear weapons production facilities will cost an estimated $100-130 billion.[8] Achieving such social goals as eliminating poverty, drug addiction and AIDS will cost even more.

How is America to pay for such goals? It is clear that unless we now make income-generating spending our highest priority, we may fail to achieve the larger societal goals we once took for granted.

The fundamental test for proposed new expenditures should thus be that they are in fact productive investments, i.e. that they promise to produce a future increase in income and productivity. Traditional measures of investment focus primarily on private sector spending on housing, plant and equipment. Considerable research in recent years, however, demonstrates that private and public spending in such areas as education, job-training, research and development, and physical infrastructure also make major contributions to productivity growth.

***How is America to pay for such goals? The fundamental test for proposed new expenditures should be that they promise to produce a future increase in income and productivity.***

For the purposes of this paper, the term "productive investment" refers to this broader definition of investment and includes:

-- private spending on plant, equipment, training, research, marketing, and distribution; and

-- public spending on education, employment and training, employment-oriented welfare reform, research and development, technology development and infrastructure.

(On occasion other measures of investment are used in this paper for purposes of illustration, and are so identified, e.g. "nonresidential fixed investment", or plant and equipment; "gross private domestic investment," the traditional measure of "investment" which includes private spending on plant and equipment, housing, and business inventories; and "net" investment, which is gross investment minus depreciation or the net addition to the capital stock.)

*In today's global economy, America's key competitive advantage will be its human capital.*

The key to such investment-led growth is increased private and public spending on the quality of America's **workforce.** Past policies have focused largely on investment in physical capital. In today's global economy, however, plant and equipment are increasingly mobile. America's key competitive advantage will be its *human* capital: the skills, knowledge, creativity, and adaptability of its workers.

Such new investments in people and technology are more important than ever because of America's competitive position in the world.

The key determinant of living standards over the long run is always productivity growth, which must therefore be our top overall priority.[9] Due to reduced productivity growth since 1973, however, the U.S. no longer retains the relative advantage in productivity necessary to offset our competitors' lower wages and cost of capital.

*The next Administration should focus as much on developing a strategy to increase productive investment as did its predecessor on promoting tax cuts.*

It is most disturbing that overall productivity growth has remained sluggish in recent years despite such favorable factors as declining oil prices, the relatively long economic expansion, and the large amount of idle resources we enjoyed when the recovery began. Some have taken heart from recent improvements in the trade deficit and manufacturing productivity. In fact, however, these have been due primarily to a weak dollar, cost-cutting, outsourcing, plant closings and corporate staff layoffs which neither raise American living standards nor lay the basis for sustained productivity increases over the coming decade.

**The next President will thus need a new strategy rather than a traditional "policy agenda," to increase the investment necessary to raise productivity and living standards.** Past Presidential economic agendas have often consisted of a list of short-term policies unrelated to overall national goals, achieved through compromises among competing interests.

In 1989, America needs a strategy that sets clear goals, and proposes policies of significant magnitude to meet them. Policies should be multidimensional, addressing the numerous

**factors which have contributed to our productivity growth slowdown - from increasing national savings and civilian research and development, to encouraging a long-term viewpoint in business and discouraging financial speculation, to improving the quality of education and training.**

## An Investment Strategy: Mobilizing America for Long-Term Domestic Investment Goals

The next President needs above all to mobilize America for action at home rather than continuing to depend on decisions made abroad. Ongoing debates over issues like protectionism distract this nation from the key issue of domestic investment which will ultimately determine our future. America needs an 'Omnibus Investment Bill', for example, far more than the "Omnibus Trade and Competitiveness Act" which has focused so much attention on foreign behavior in recent years.[10]

The last time America set a great national goal was in 1961, when it reached out into space. In 1989, the United States needs to establish an even more ambitious objective: matching our top competitors' savings and investment performance by the year 2000, so as to keep America on the cutting-edge among world industrial powers.

America has led the world for so long that many Americans still do not realize that we are falling behind in such basic indicators of economic health as the quality of our capital markets, labor and technology. The U.S. has little choice but to meet such *quantitative* goals as matching our competitors' investment and savings performance if we also wish to match their standard of living.

The new President also needs to set such *qualitative* long-term objectives as producing a more *efficient* America by increasing the number of more entrepreneurial, long-term and quality-oriented corporate managers, more professional teachers, better students, and a more productive workforce by the year 2000.

And he must aim for a *fairer* America as well, one that would set goals that ensure greater workplace democracy, employment security and family support in return for improved job performance; a smaller underclass produced by increased pre-school and compensatory education, employment-oriented welfare programs and a new national ethic of both self-reliance and community; increased progress toward pay equity; and a tax system perceived as equitable by all Americans.

## An Investment Strategy: Developing Policies Sufficient to Achieve Stated Goals

After setting long-term quantitative and qualitative goals, the next President should propose *annual* policies of sufficient magnitude to achieve them. It is not enough simply to support "more investment." Proposed policies should increase productive investment by designated annual objectives.

Given the sharp decline in national savings during the past years, and the risk of renewed inflation, the shift from debt-financed consumption to investment-led growth will need to be gradual. But it will also need to be dramatic - as this nation commits to a slow, steady and sustained annual increase in productive investment for the foreseeable future.

Needed policies encompass at least six key areas - deficit reduction, savings incentives, removal of Social Security from the unified budget, private investment incentives, increased public sector investment, and promotion of global growth.

*Although "supply-side" economics was supposed to boost savings and investment, the last seven years have seen a significant decline in net savings and non-residential investment.*

Such a proposed "national investment strategy" does not envision greater government intervention or economic planning. On the contrary. This strategy recognizes that America's success depends upon the entrepreneurialism and creativity of its private sector, and seeks to strengthen it by (a) providing the overall savings and investment incentives that are vital to private-sector expansion, particularly for small and medium-sized enterprises; and (b) improving the public underpinnings for private-sector performance - such as education, training, infrastructure, and research and development.

But although not national planning, such an "investment economics" would certainly constitute a new national priority. The next Administration should focus as much on developing a strategy to increase savings and productive investment as did its predecessor on promoting tax cuts and a military buildup.

## II. INVESTMENT ECONOMICS: TOWARDS A NEW CONSENSUS

The case for doing so is straightforward: although "supply-side" economics was supposed to boost savings and investment, its implementation in the last seven years has in fact seen a significant decline in net savings and non-residential investment, and a rise in the share of the national income consumed.

National savings dropped from an average of 7.4% of full-employment GNP from 1960-80 to 2.2% between 1982 and 1987. In 1986, net national savings hit a post-war low of 1.7%,[11] and was one-tenth the rate of Japan, and one-fifth that of West Germany.

Net private domestic investment has averaged only 5% of GNP from 1981-87, a 30% drop from its 7.1% average between 1951 and 1980. The U.S. has gone from being the world's largest creditor in 1983 to its largest debtor, with nearly $500 billion owed to foreigners today. Much of this debt has fueled consumption, which has grown 22% faster than output in the last three years.

And key public investments have also declined during this period. Federal outlays for major nondefense physical capital investment as a share of total outlays averaged only 1.2% in the 1980s, compared to the 1.9% post-war average. The average share of the Federal budget invested in nondefense research and development from 1981-1987 was 27% less than the 1951-80 average. And Federal outlays on education and training fell from 4.7% of the budget in 1979 to 2.2% in 1987.

An increasing portion of the investment we do enjoy, moreover, is subject to foreign decisions over which we lack control. Foreign capital amounted to more than 67% of net investment in 1986, for example.[12] Meanwhile, our top competitors have improved their overall domestic savings position, and widened an "investment gap" in key areas like non-defense R&D - where the Japanese outspend us by almost 50% as a share of GNP.[13] Japanese firms today enjoy a cost of capital advantage approaching 4 to 1 over American firms, allowing them to gain market share in older and newer sectors - and the gap is growing.[14]

This deterioration in the savings/investment process - the lifeblood of an economy - is unprecedented for a modern industrial nation experiencing a recovery. And it will pose even greater problems over the coming decade when, as is inevitable, foreign lending slows and/or the next recession begins.

Although most economists and policymakers would agree that restoring the process of productive investment should be America's top priority, public economic discourse over the last seven years has tended to focus on other areas of disagreement - such as the proper role of government in the economy. Recently, however, there has been an evolving consensus among economists of all persuasions that it is more important to get on with savings and investment than pursue the debates of the past.

There is growing agreement among economists, for example, that we need *both* "macro" and "micro" investment-oriented economic policies more than continued debate over the relative importance of each; that improving both business and government performance is more important than seeking to increase the relative size of either; that the key to solving the trade deficit is to produce quality products at home rather than focusing our attention on the far smaller portion affected by foreign practices abroad; and that investment in the *people* who will work in increasingly interdependent manufacturing and service sectors is more significant than policies geared to one sector or the other.

***The key determinant of living standards over the long run is always productivity growth. Increasing productivity depends upon capital, labor and technology.***

Economists, including the authors of this article, continue to disagree on significant issues. But we believe that what unites us - a concern for restoring the process of savings and investment - is far more important than what divides us, and that this is true for a growing number of our colleagues and policy-makers.

Despite this emerging consensus, the next President is likely to face considerable political pressure to pursue more short-term goals that will fail to restore savings and investment to internationally competitive levels.

Some may, for example, suggest that America concentrate on strategies which amount to continued borrowing or selling off of

American assets to maintain short-term growth without regard to long-term consequences.

It is, of course, impossible to predict with certainty whether such short-term strategies will "work," e.g., whether foreigners will continue lending or investing in the U.S. in sufficient quantities to permit debt-led growth over the next four years. But one *can* safely predict that even if such "muddling through" strategies succeeded in preventing a recession in the short run, they will do little to halt long-term decline - threatening America's living standards and great power status by the year 2000 or before.

America simply has no alternative to steady and sustained deficit reduction and increased productive private and public investment if it is to have a strong economy by world standards twelve years hence.

It is also likely that a comprehensive "investment economics" strategy *can* work for the long-term. Most of our problems were caused in the last decade, and can be set right in the next one. If America seeks gradually and carefully to shift its resources from consumption to productive investment between now and the year 2000, we can prevent the national decline feared by so many, and help usher in a new era of domestic and global prosperity.

## III. INVESTMENT ECONOMICS: THE NEED

The fundamental test of any economic policy is its ability to produce a sustained and steady rise in the living standards of its people. A policy that uses foreign borrowing to raise short-term income, for example, is insufficient if foreign lending then ceases and provokes a dramatic drop in national well-being. And such goals as reducing the trade deficit or unemployment are only acceptable if they are accompanied by rising wages. Few Americans would support a deliberate policy to reduce the trade deficit and maintain employment by dramatically cutting incomes and living standards.[15]

***Present trends, moreover, will likely see America's capital position worsen vis a vis its competitors in the 1990s.***

Increasing living standards in turn depends upon increasing the quantity and quality of the three key inputs into economic growth: capital, labor and technology. Only as a country can match its top competitors' capital costs, workforce skills, and product and process technology can it see productivity gains match those of its competitors and thereby produce a higher standard of living for its people.

All of these indicators of national well-being - living standards, productivity, capital, labor and technology - have been inadequate in the past decade, both in comparison to our post-war past and the present performance of our top competitors. America's need for an "investment economics" is rooted in the growing urgency to reverse these trends.

Restoring the process of savings and investment will not by itself guarantee a strong American economy in the year 2000. But it is the necessary first step, the essential precondition for realizing the promise of rising living standards from higher productivity.

And it is a first step that should be taken now. After a decade of declining savings and stagnant investment, continued delay poses an unacceptable risk to the future well-being of America. To understand why, it is necessary to look in more detail at the erosion in the underpinnings of the American economy.

## Living Standards

America has been experiencing a "quiet depression" in living standards since 1969. Real family income was only slightly higher in 1985 than in 1969, and growth in annual incomes of adult workers has slowed considerably in recent years.[16] Our competitors' living standards, meanwhile, have been growing far faster than our own. Between 1970 and 1986, manufacturing wages expressed in dollars grew 14.3% in Japan and 11.2% in West Germany, compared to only 7.2% in the United States.[17] In 1970, U.S. manufacturing wages were 4.5 times higher than in Japan. By 1987, the ratio had fallen to about 1.0.[18]

American living standards will be under even greater pressure in the coming decade. The U.S. inevitably will be forced to eliminate its trade deficit, and doing so means that Americans will no longer be able to consume 3.5-4.0% more of GNP than we produce. And, without a huge burst of productivity, annual interest payments on the debt already incurred in the 1980s will reduce future American living standards by another 2.5-3.0%.[19] And a prolonged recession could reduce income even further.

## Productivity

Although American workers are still the world's most productive, *productivity growth* has been declining both by historical levels and in comparison to our main competitors. Overall U.S. productivity grew only 0.8% annually from 1970-87, compared to 3.4% in Japan, 2.7% in France and 2.4% in Germany,[20] and Japan and Germany have essentially caught up with the United States in manufacturing productivity.

U.S. manufacturing productivity has grown 3.1% annually between 1979 and 1986. While this is indeed a healthy development, it directly affects only the 20% of American workers involved in manufacturing, and is still less than the average 5.5% manufacturing productivity growth enjoyed by the Japanese during the same period. Overall, U.S. manufacturing productivity growth averaged only 2.9% annually from 1970-86, compared to 6.0% in Japan, 4.2% in France, and 3.8% in Germany.[21]

## Capital

A major obstacle to increasing productivity is the fact that American firms face a far higher cost of capital than their top competitors. Foreigners' 4:1 capital cost advantage has been a key factor allowing them to gain market share in such strategic areas as autos, steel, consumer electronics and semiconductors. When Honda Motors set out to capture U.S. market share in 1965, for example, its return on assets fell from 9% to an average 3% for the next 15 years. By the mid-1980s, however, it had grown from a

$400 million to a $20 billion company, with return on assets of 8.5%. An American company would find it difficult or impossible to make the same long-term commitment to gaining market share, given its difficulty in attracting long-term, low-cost patient capital.[22]

*The next recession will be the first in post-war history in which the Federal government will enter with large budget deficits. Our top competitors' vast cash reserves will, by contrast, make it easier for their firms both to weather a recession and continue to gain market share.*

A lower cost of capital has allowed the Japanese to invest far more in plant and equipment than the United States. In 1980, the Japanese fixed investment per employee was some 50% more than in the United States. By 1985, they were spending twice as much - helping to increase their market share, wages and employment.[23] The situation is equally serious in the service sector where, for example, German capital investment per person in services is also twice that of the United States.

Present trends, moreover, will likely see America's capital position worsen vis a vis its competitors in the 1990s. The higher cost of capital experienced by American firms in the 1980s has occurred despite a major influx of foreign capital. In the likely event that foreign lending is significantly reduced in the 1990s, the cost differential could increase even further.

A recession would augur even greater difficulties. Many U.S. businesses would be hard-pressed to continue to do more than service their debts and cope with possible layoffs in the event of a slowdown. Many U.S. banks could be even more vulnerable, not only from domestic but international debt repudiation. And the next recession will be the first in post-war history which the Federal government will enter with large budget deficits, making it difficult to do more than meet human needs and avert major bankruptcies. Our top competitors' vast cash reserves will, by contrast, make it easier for their firms both to weather a recession and continue to gain market share and innovate throughout it.

## Labor

Labor has become increasingly critical to boosting productivity in recent years. As capital and technology are increasingly mobile, America's key competitive advantage will lie in the skills, knowledge and flexibility of its workforce.[24]

The inadequate productivity growth of the U.S. workforce is due to a number of factors, particularly the declining competitive performance of the bottom half of our workforce - at a time when new jobs demand greater technical competence than ever before. One of every five workers is functionally illiterate, one of every ten handicapped by drug or alcohol addiction. Many minority youth have never even held a job, while employers are going begging for workers in many sections of the country. In contrast, nations like Japan have a workforce which enjoys near-total literacy and far more effective technical training.[25]

***There are no short-term solutions. Shifting the nation from short to long-term economic thinking is perhaps the most important challenge facing the next President.***

We face even greater workforce challenges in the coming decade. An estimated 85% of today's workers will still be in the labor force in 2001, and are expected to change jobs and careers far more often than their parents. Over two-thirds of new entrants into the workforce will be minorities and women, two groups traditionally lagging in technical, mathematics and science background.[26] The gap is growing with our competitors in the development of scientific, engineering and technical personnel for the civilian sector. And far more workers need family support like child care and parental leave than before, since most American households are today headed by one or two working parents. The aging of the workforce will also pose new challenges in the coming decade.

Such new workforce conditions will require far more public and private investment in training, career counseling and family support, at a time when budget deficits and shrinking private-sector profits will lead to pressures to reduce even today's inadequate workforce efforts.

## Technology

America's relative technology performance has also been declining for the last several decades, most notably in process and product development. Japanese basic manufacturing skills have not only seen them gain market share in older sectors like autos and steel, for example, but also in high-technology fields like electronics where the U.S. has experienced a trade deficit for the last five years. Huge markets have been lost in consumer electronics, including a $6-billion-a-year U.S. market in videocassette recorders, as well as more basic markets like 256K and 1 megabyte memory semiconductor chips. In 1985, the Japanese outspent the U.S. by 47% in share of GNP devoted to civilian R&D (2.8% vs. 1.9%), more than twice the 18.5% average difference from 1971-80.

And, as with capital and labor, the challenge to America's technology lead is expected to intensify in the coming decade. The Japanese already lead in introducing robotic technologies for flexible manufacturing and other process applications. They are developing new consumer products like High-Definition Television, which will not only constitute a significant market itself but drive Japanese commercial innovation in other areas. And they are even challenging our heretofore impregnable lead in laboratory innovation in such new areas as optoelectronics, advanced materials and superconductors.

## Infrastructure

In recent years, the nation's lack of investment in its physical infrastructure has also declined. A recent study by the National Council on Public Works Improvement found, for example, that "the quality of America's infrastructure is barely adequate to fulfill current requirements, and insufficient to meet the demands of future economic growth and development." It recommended doubling the amount of capital the nation invests in public works annually by the end of the century - or some $45 billion annually in real terms.[27]

## An "Investment Economics" For the Long-Term

These new challenges to American living standards, productivity, capital markets, labor and technology not only point to the need for greater savings and investment. They demonstrate also that there are no short-term solutions. An "investment economics" strategy will require a steady and sustained effort, perhaps as long as a decade, to reverse declining trends.

Shifting the nation from short to long-term economic thinking is perhaps the most important challenge facing the next President. He must of course seek to maintain short-term growth. But America will only succeed if he can do so in a way that also sees the nation gradually and steadily increase savings and productive investment to the level of our top competitors over the coming decade.

Bringing the long-term into short-term economic policy-making will, of course, represent a dramatic shift from our recent past. We developed patterns of short-term thinking throughout our society in the prosperous 1950s and 1960s, when quarterly profit and loss statements went together with long-term market share, government deficits were insignificant, and America's labor force and commercial products were a world standard.

*Bold goal-setting for savings and investment has become a key to rising living standards in the year 2000.*

It is worth recalling, however, that earlier generations of Americans practised the kind of long-term thinking that tamed a continent and constructed the world's most extensive infrastructure. It is time to incorporate these earlier traditions into our future economic policy-making.

# IV. INVESTMENT ECONOMICS: GOALS FOR THE YEAR 2000

Although America has successfully set such national objectives as building a Federal highway system or conserving energy, we have never established overall investment or savings goals. Our economic strength appeared to make such goal-setting unnecessary, and many Americans have come to see it as inimical to our "free market" traditions.

In today's new world in which top economic competitors regularly outperform us, however, bold goal-setting for savings and investment has become a key to rising living standards in the year 2000.

If America is to remain competitive, we must not only boost savings and productive investment - but do so by an amount sufficient to match our top competitors' performance by the year 2000. Goal-setting can aid this process by (1) providing objective benchmarks to ensure that America is in fact boosting savings and investment enough to keep it a world-class power; and (2) helping to develop the private and public consensus necessary to achieve these goals.

Let us say, for one example, that the nation set a goal of matching Japanese nonresidential fixed investment rates by the year 2000. National leaders could then propose a set of policies annually that would move us toward this goal, and seek to mobilize the private and public sectors to achieve them.

Absent clear goals, it is difficult to propose coherent policies. If America wishes to match its top competitors' rise in living standards between now and the year 2000, for example, it will not be sufficient simply to raise net savings from 2 to 4% of GNP over the coming decade, or gross investment from 15 to 16%. We have no way of knowing if policies proposed to "boost savings" or "raise investment" will in fact contribute to world-class living standards unless we establish world-class savings and investment goals.

And to the extent such goal-setting does boost savings and investment, it will also strengthen the free market. The market, after all, only works within the bounds of basic parameters set by society - workforce literacy, the amount of savings, and investments in technology. The private sector has historically responded when the public sector has set credible goals for such basic inputs and met them.

*Numerous governors have in recent years won broad support for such state investment goals as better education, transportation and economic development. Following such precedents, the next President can rally America to meet the commercial challenge.*

The next President should establish a National Investment Commission to set savings and investment goals for the year 2000, as well as annual national benchmarks to measure our progress towards them. Such benchmarks should include both quantitative and qualitative objectives.

It is particularly important that such priorities be translated into annual and concrete goals that all Americans can understand.

The last President began his term by talking of "family" and "work". The next should augment such concerns with a focus on "schools," "factories," "wages," and "jobs." The Commission should highlight such concrete outputs as the numbers of new science and math teachers, new products gaining market share, or former welfare recipients placed in productive jobs.

## Assigning a Priority to Domestic Investment

Perhaps the most difficult task the next President faces is conceptually the simplest: making *domestic investment* his Administration's highest priority. While few oppose "productive investment" in theory, most of us have other priorities in practice - from short-term consumption to social, environmental or military spending. As a democracy, America has a tendency to avoid setting goals and instead develop policies reflecting a compromise among competing interests. And the difficulties of changing course at home tempt many to blame foreigners for our problems.

Strong presidential leadership will thus be required to convince Americans that only if we rebuild the foundations of our economy can we afford our other societal goals.

If the next President chooses to exercise such leadership, however, both history and recent state-level experience suggest the American people will respond. Presidents Eisenhower and John F. Kennedy rallied America to meet the technological challenge posed by the launch of Sputnik. And numerous governors have in recent years won broad support for such state investment goals as better education, transportation and economic development. Following such precedents, the next President can rally America to meet the challenge posed by our top competitors' commercial success.

## Long-term Quantitative Goals: Boosting Savings and Productive Investment

If America is to have a world-class economy in the year 2000, a commitment to "productive investment" will need to include *quantifiable* goals. While it is not possible to set precise targets, we should seek to establish concrete benchmarks to inform Americans as to whether their country is rebuilding its productive base over the coming decade.

As discussed below, an important element of "investment economics" is reforming spending in key income-producing areas. Any new investments should be accompanied by painstaking efforts to ensure that resources are used effectively. Nonetheless, it is unlikely that America will have a world-class economy in the year 2000 unless it successfully increases its productive investment.

Two basic principles should guide an attempt to establish national investment benchmarks: (1) meeting the strategic investment performance of our top international competitors; and (2) increasing internally-generated investment so as to rely as little as possible on foreign capital (while productive foreign investment can be useful, we should not continue to *rely* upon the vagaries of continued foreign investment.)

The most important long-term goal for America is to boost productivity, which is the key to increasing living standards. It is difficult, however, to calculate a given set of policies which will translate into increased national productivity over a limited time period like the next 5-10 years. The next President, therefore, should focus on setting quantitative goals for savings and productive investment which can be directly affected by policy levers under his control. Over time, a significant boost in such savings and productive investment will translate into productivity increases, as they have both here and in Japan during the post-war era.

***America should seek to match Japan's 23% plant and equipment investment rate by the year 2000 and similarly ambitious goals for investment in education, training, R&D, and infrastructure.***

The kind of quantitative long-term benchmarks that should be considered include:

**(a) Internationally competitive levels of productive investment**

America should also set ambitious goals for boosting productive investment. At a minimum, we should seek to match Japan's 23% plant and equipment investment rate by the year 2000 (gross nonresidential fixed capital formation as a percent of GDP). And we should set similarly ambitious goals for other forms of needed public and private investment - including education, training, R&D, and infrastructure.

**(b) An internationally competitive national savings rate**

Domestic investment, of course, equals domestic savings plus foreign capital. If America is both to invest more and rely upon foreigners less, it will need to save more. The United States should seek to raise net national savings by at least 1% of GNP annually between 1989 and 2000, to ensure we at least match the 11% levels enjoyed by our top competitors.[28]

## Interim Quantitative Objectives

In addition to setting long-term goals, the next President should also establish annual benchmarks for achievement. At a minimum, we should seek to have GNP growth exceed consumption growth by 1% annually, with the difference used to boost productive investment and reduce the trade deficit.

Such a policy would make a significant difference in America's economic behavior. By way of illustration, let us assume that GNP had grown by 3% between 1985 and 1987, consumption had grown by 2%, and the difference had been allocated evenly between increased investment and a reduction in the trade deficit.[29] Under these circumstances:

-- Investment would have grown by $62.7 billion in 1982 dollars, rather than registering its actual drop of $8.5 billion - a $71.2 billion difference;

-- The trade deficit would have stood at $41.6 billion at year-end 1987, rather than its actual level of $128.9 billion.

(Please see Appendix B.)

In addition to overall annual investment levels, the next President should establish secondary goals for matching our international competitors' performance in key capital; labor and technology sectors.

For example, the United States would have needed to increase its spending on civilian R&D by an additional 0.9 percent of GNP to have matched the Japanese rate in 1985. Had the Japanese share of GNP remained constant between 1985 and 1988, the U.S. could have closed its civilian R&D gap with Japan by increasing R&D expenditures by $15 billion annually during this period.

Such concrete, achievable benchmarks need to be set for the years between 1989 and 2000, and the American people informed of our progress toward them.

The media and public now gauge the performance of our economy by such *short-term* indicators as GNP growth, unemployment or inflation. A National Investment Commission should seek to establish other indicators for measuring our *long-term* economic performance.

***The next President should also move to establish qualitative goals to assure that new investments will be used more effectively and equitably than they have in the past.***

In addition to tracking gross investment, net savings, and productive investment levels, for example, the Commission might place a greater national spotlight on such indices as numbers of civilian engineers, salary levels of teachers, numbers of displaced workers trained, the school dropout rate, bridges repaired, and productivity growth rates.

## Qualitative Goals and Objectives: Effectiveness and Teamwork

The next President should also move to establish *qualitative* goals to assure that new investments will be used more **effectively** and **equitably** than they have in the past. A new vision is needed of a more productive and fairer America.

### (a) Towards a more productive America

America needs, for example, a vision of a modernized private sector in the year 2000 that includes (a) increased savings, allowing capital markets to provide low-cost, patient capital to small, entrepreneurial firms as well as larger ones; (b) a corporate management more oriented to gaining long-term market share than short-term profits and more committed to the kind of team management practised by the Japanese; (c) a workplace with greater democracy, employment security, family support, and accountability; and (d) more industrial consortia seeking to combat larger foreign firms in developing cutting-edge technologies.

We also need to set such qualitative education and training goals as (a) professionalizing teaching by shifting resources to classroom teachers and giving them new opportunities for advancement in return for greater accountability; (b) emphasizing greater math, science and language teaching to create a more competitive workforce, e.g. one that knows the math necessary to do statistical quality control; (c) providing preschool and compensatory education to all eligible students - a key to preventing illiteracy and school dropouts; (d) setting higher standards for students; and (e) developing more effective job-training by involving employers in the design and implementation of all vocational, displaced worker and other job training efforts.

### (b) Towards a fairer America

The last eight years have shown that no economic strategy can be implemented absent a successful political strategy that can achieve it. Almost all economists have urged significant deficit reduction, for example. If we have failed to reduce it sufficiently, it is for lack of a *political* not economic consensus.

The political key to any attempt to shift America from a high consumption to a high investment society in the 1990s will be doing so in a fair and equitable manner.

***The political key to shifting America from a high-consumption to a high-investment society in the 1990s will be fairness.***

Numerous public opinion polls suggest there is a widespread public perception that the poor have not participated as much as the rich in the recent recovery. Census data shows that the income shares of the bottom 80% of the population have fallen from 1980 to 1986, and that most of the income gains of the top 20% have gone to the top five percent of the population.

America's investment needs are so great between now and the year 2000, moreover, that no one group of Americans can be expected to finance them. If all Americans will ultimately be asked to bear the burden of investment, they will require that those who can most afford it pay an equitable amount.[30] The first step to any credible investment program will thus be ensuring that those who gained most from the policies of the past decade pay their fair share during the next one.

Fairness is also the key to boosting productivity and the quality of the workforce - particularly among the minorities who will comprise a growing portion of new workers between now and the year 2000. America must reduce the underclass, illiteracy and school dropout rates if it is to increase workforce productivity.

America needs to create more "teamwork" among every sector of our society - through strategic alliances within the private sector, public~~-private-~~partnerships among government, business and academia, and effective regional and local economic organizations. Only as new partnerships are created will America be able to muster the resources needed to compete with more united economic adversaries.

## V. INVESTMENT ECONOMICS: POLICIES FOR THE YEAR 2000

If the next President is to launch America on a trajectory that will see it match its competitors' investment levels in the year 2000, he will need to propose a coherent set of policies that can generate desired levels of productive investment. Proposed policies should thus meet two basic criteria:

(1) each should demonstrably increase productive investment; and

(2) taken as a whole, they should generate sufficient savings and investment to achieve the President's overall annual goals.

***Investment-oriented deficit reduction is an essential precondition to boosting overall investment.***

Policies should, moreover, be tied to proposed results. Neither tax increases nor tax cuts, for example, should be seen as ends in and of themselves. Rather, they should be part of an overall initiative that will concretely generate improved plant and equipment, infrastructure, commercial products, schools, students, workers, jobs, and national savings.

Policies should also seek to unify through a politics of compromise. America will not generate the level of investment it needs until all groups detail first what *they* are willing to contribute to the cause of rebuilding America's economy, in return for contributions by others. Those business leaders who correctly urge investment tax incentives, for example, might propose funding them out of upper-income tax hikes. Those urging military spending cuts might also detail the progressive restraints on entitlements or cuts in consumption they are also prepared to ask their constituents to absorb.

As America sets strategic goals and develops the policies to achieve them, it might consider the following kind of policy framework:

## Strategic Goal #1: Match Our Competitors' Savings Performance

### (a) Reduce the Federal deficit

The single most reliable way to boost the national savings rate is to reduce Federal dissavings by cutting the Federal deficit. [31] Deficit reduction is an essential precondition to boosting overall investment, so long as spending is not cut on income-generating activities like education and training, and taxes are not increased which significantly discourage productive investment. Conducting such deficit reduction in the later stages of a recovery also requires, of course, offsetting domestic monetary expansion and greater imports by major allies in order to lessen the risks of global recession.

The next President should seek to cut the Federal deficit in 1989 by some $40 billion (roughly 1% of GNP), assuming that allies increase their spending by a similar amount and that monetary policy is commensurately eased to prevent a slowdown.

Needed spending cuts should exempt areas of critical public investment like education, job-training, employment-oriented welfare reform, commercial research and development, infrastructure, and child care. Any necessary revenue increases should also not discourage investment. If revenues are passed, they should include such measures as higher taxes on alcohol and tobacco, foreign capital income, and short-term stock transfers.[32]

If further revenues are needed to reduce the deficit, they should seek to balance the twin needs of equity and efficiency as much as possible. If the highest-bracket taxpayers are asked to fund deficit reduction, for example, they must be assured that revenues will in fact reduce the deficit and not simply be used to continue spending. If broad-based consumption and/or gasoline taxes are to be passed, they should be as progressive as possible - including rebates to low-income taxpayers and those who do not earn enough to pay income taxes - and be part of a package that includes higher upper-income taxes.

***If broad-based consumption and/or gasoline taxes are to be passed, they should be as progressive as possible, and be part of a package that includes higher upper-income taxes.***

**(b) Provide savings tax incentives**

New tax incentives are needed to encourage savings and discourage excessive consumption. We should provide such positive incentives as reformed Individual Retirement Accounts (IRAs) that do not permit people to shift savings from old to new accounts, or to borrow for their IRAs. And we should end distortions in the tax code that continue to reward debt and penalize saving.

**(c) Remove Social Security from the unified budget**

The present practice of using Social Security surpluses to fund current account deficits is harmful to the cause of capital formation, the goal of reducing the Federal budget deficit and, ultimately, Social Security itself. National savings would be considerably increased by separating Social Security from current budgeting, encouraging policy-makers to reduce the deficit by investment-oriented spending cuts or revenue increases. We should also consider ways to allow Social Security surpluses to be safely invested in productive enterprise.

## Strategic Goal #2: Match Our Competitors' Private Investment Performance

Tax incentives need to be extended to increase investment, and to discourage excessive speculation and consumption. Tax reform should be revisited to provide effective incentives to individuals to save and businesses to invest.

Higher savings will contribute to lower capital costs. But the need is so great that we should contemplate further tax incentives for business investment. Redesigned investment tax credits targeted for modernization, effective accelerated depreciation for plant and equipment, and elimination of double taxation on returns to long-term equity investments - perhaps funded by a surtax on short-term gains - need to be considered. The existing R&D tax credit should be made permanent, if not increased, and carefully designed tax credits for on-the-job training also need to be considered. All investment incentives should be limited to new capital or new equity.

It is particularly important that incentives be given to pension-fund managers to make longer-term investment decisions than is now the case. We should consider instituting sliding-scale taxes that would encourage managers to invest for the long-term, perhaps funded by penalties for excessive pension fund churning.[33]

Excessive merger and acquisition activity has unfavorably affected rates of investment, depleted equity holdings, and promoted precarious levels of leverage. A major cause of such activities is the gap between the cost of equity and the cost of debt. Tax reform that narrows that gap and addresses the fundamentals of the problem would complement attempts to reform capital markets.

***Special attention should be given to supporting industries that wish to form manufacturing process consortia to compete internationally in commercializing cutting-edge technologies.***

Finally, this nation should actively explore the issuance of small denomination "investment bonds" that would give average Americans the opportunity to invest in their country's future. Unlike savings bonds, the proceeds from which go to the general treasury, investment bond proceeds would be targeted for education, training, or industrial modernization.

Ideally, such investment bonds would be seen by purchasers as both a safe investment and a way to support their country. Such bonds could be a significant source of funds for modernizing America. In 1987, for example, the U.S. Treasury sold over $10 billion worth of savings bonds. Perhaps equally significant, a properly designed "investment bond" campaign can help educate Americans about the need to invest in their nation.

## Strategic Goal #3: Match Our Competitors' Public Investment Performance

Public investment is likely to be more critical in the 1990s than ever before - as America copes with new workforce, infrastructure and research challenges. While the deficit must be reduced, key public investments need to be increased.

**(a) Increase public investment in modernization and infrastructure**

Special attention should be given to supporting industries that wish to form manufacturing process consortia to compete internationally in commercializing cutting-edge technologies, as has occurred to date with the semiconductor and machine-tool industries. If industry is willing to pay at least 51% of the cost of such consortia, public support in the form of tax incentives, grants, and/or loan guarantees should be considered. So too should "industrial modernization agreements" whereby public support for a cutting-edge industry is conditioned upon a commitment to modernize. And there needs to be greater public spending on our physical infrastructure, balanced by revenue increases - such as user fees - to pay for it.

The proposal to guarantee pension fund investment in key areas of economic need like infrastructure also needs to be considered - along with proposals to allow pension funds to invest more in small and medium-sized businesses, and industrial modernization.

**(b) Increase public investment in people**

The next President should emphasize K-12 education reform, giving impetus to efforts to professonalize teaching, increase accountability and performance of both teachers and students, promote public choice, and raise learning standards. K-12 spending priorities should include increasing funding for compensatory education to prevent dropouts and illiteracy, promoting the effective use of learning technologies, and encouraging math and science teaching.

A major education funding priority, however, should be in post-secondary education - the traditional focus for Federal education efforts. The basic principle should be established that no student or adult be denied access to post-secondary education for which he or she is qualified for lack of funding. A stable Trust Fund should be established to invest in the college and/or vocational education of all American students and adults, perhaps to be repaid through modest lifetime surcharges on payroll taxes.

***A major education funding priority should be in post-secondary. A stable Trust Fund should be established to invest in the college and/or vocational education of all American students and adults.***

The next President should also propose policies that focus on increasing on-the-job training and retraining for employed workers, as well as for employees who are displaced. Individual Training Accounts and tax credits for private-sector job-training are needed, as well as an expansion of Federal support for job-training for the hard-to-employ.

A particular priority should be placed on recent welfare reform efforts which require work by all recipients with children over three in return for training and employment support.

Perhaps the most important *new* area in which the next President should move is in providing family support and incentives for workplace democracy that gives workers a greater control over their worklives so as to boost motivation and productivity. New initiatives are needed to provide child care and parental leave at the workplace, along with incentives to promote more autonomy and initiative on the shopfloor and in the office.

### (c) Promote Global Growth

Finally, the next President will need to do more to promote global demand so that investment at home ultimately leads to increased exports. An immediate priority will be greater macroeconomic cooperation with key allies like Japan and West Germany, so that they expand their economies commensurate with our deficit reduction. If the United States cuts its budget deficit by $40 billion annually for the next four years, for example, our allies should expand their domestic economies by a similar amount.

The United States must also move more vigorously to resolve the international debt crisis, so that the Third World can once again become a growing market for our exports. To do so, the next President must not only embrace the principle of partial debt relief, but look for new and creative ways to expand mass purchasing power in the Third World.

## VI. CONCLUSION: INVESTMENT ECONOMICS - THE PRUDENT COURSE

The investment economics described above would represent a departure for a United States that has grown used to debt-driven consumption during the past decade. There will be some, perhaps, who will suggest that it is too risky to seek to shift significant resources into productive investment, even if done gradually.

It is our belief, however, that this is the most prudent of policy options open to America, and that it is our present reliance upon foreign borrowing and excessive consumption that is by far the riskier path. We are unaware of any historical precedent that has seen a nation indefinitely borrow and consume its way to prosperity. And we note that the world today is filled with the descendants of once-great powers that tried this path and failed.

***It is wrong to gamble the future of a country on accomplishing a feat which no nation in history has achieved.***

Perhaps the greatest danger we face today is the complacency that lulled these former powers into inaction. It is possible that America can avoid hard choices during the next four years by devising new forms of borrowing and consumption. And some, thinking only of the short-term, may advocate that we take this path of least resistance.

To do so, however, would be imprudent. For no matter what our short-term prospects, an attempt to continue the debt-financed consumption of the last eight years for another decade risks reducing the United States to a second-rate economic power like Great Britain, Spain and France before us.

It is wrong to gamble the future of a country on accomplishing a feat which no nation in history has achieved. The time has come instead to take the safer path of relying upon our own resources and strengths to rebuild this nation's economy from the bottom up.

We are optimistic, moreover, about America's ability to do so. Still a relatively young power among the great nations, America has a unique capacity to innovate, significant institutional flexibility, and the resources to both meet human needs and invest for its future.

The American people have demonstrated their willingness to change course. Numerous governors around the country, for example, have passed major investment initiatives that have seen their states raise taxes for investment in education, transportation, economic development and deficit reduction. And public opinion polls confirm that people are prepared to invest in America provided they are assured that their investments are needed, used wisely, and raised and distributed fairly.

What is needed now is a new President and Administration that can take this state-level experience and turn it into national policy. If the next President offers this leadership, America can not only reverse its decline - but enjoy the world's highest living standards as the new millennium begins.

## APPENDIX A: U.S. PRODUCTIVE INVESTMENT

(percent of GNP)

| | 1955 | 1960 | 1965 | 1970 | 1975 | 1980 | 1985 | 1986 |
|---|---|---|---|---|---|---|---|---|
| Nonres. investment (1) | 13.53 | 12.02 | 10.37 | 10.36 | 10.19 | 11.82 | 11.03 | 10.23 |
| Nondefense R&D (2) | 0.94 | 1.60 | 1.90 | 1.72 | 1.63 | 1.79 | 1.85 | 1.87 |
| Fed'l education (3) | 0.03 | 0.07 | 0.08 | 0.16 | 0.16 | 0.22 | 0.20 | 0.19 |
| State & local education (4) | 4.13 | 4.53 | 4.27 | 5.37 | 5.81 | 5.18 | 5.09 | 5.19 |
| Private educ. & research (5) | 0.87 | 0.96 | 0.82 | 0.99 | 1.02 | 1.00 | 1.08 | 1.12 |
| Fed'l labor & training (6) | 0.03 | 0.02 | 0.06 | 0.09 | 0.04 | 0.08 | 0.05 | 0.04 |
| State & local training (7) | 0.07 | 0.07 | 0.07 | 0.09 | 0.14 | 0.16 | 0.10 | 0.10 |
| Federal transportation (8) | 0.24 | 0.34 | 0.27 | 0.28 | 0.31 | 0.33 | 0.25 | 0.23 |
| State & local transport. (9) | 2.12 | 2.19 | 1.72 | 1.70 | 1.53 | 1.32 | 1.30 | 1.34 |
| **Investment/ GNP*** | **21.96** | **21.80** | **19.56** | **20.76** | **20.84** | **21.90** | **20.99** | **20.40** |
| Net foreign investment/GNP | 0.10 | 0.62 | 0.88 | 0.47 | 1.35 | 0.48 | -2.85 | -3.36 |
| **Savings/GNP*** | **22.06** | **22.42** | **20.44** | **21.23** | **22.19** | **22.38** | **18.14** | **17.04** |

*Due to lack of data, corporate spending on job training is not included in totals.

## Sources

1) **Gross nonresidential fixed investment** - Includes structures and producers' durable equipment. (U.S. National Income and Product Accounts, Table 1.1, Line 8)

2) **Nondefense research and development** - Includes both public and private R&D expenditures (U.S. National Science Board, *Science and Engineering Indicators*, page 237)

3) **Federal government spending on education** - Adjusted to avoid double-counting grants to state and local governments ( U.S. National Income and Products Accounts, Table 3.15, Line 20)

4) **State and local government spending on education** - (U.S. National Income and Product Accounts, Table 3.16, Line 9)

5) **Private spending on education and research** - Personal consumption expenditures on education and research (U.S. National Income and Product Accounts, Table 3.16, Line 40)

6) **Federal government spending on labor and training and services** - Adjusted to avoid double-counting grants to state and local governments (U.S. National Income and Product Accounts, Table 3.15, Line 78)

7) **State and local government spending on labor training and services** - (U.S. National Income and Product Accounts, Table 3.16, Line 40)

8) **Federal government spending on transportation** - Adjusted to avoid double-counting grants to state and local governments (U.S. National Income and Product Accounts, Table 3.15, Line 67)

9) **State and local government spending on transportation** - (U.S. National Income and Product Accounts, Table 3.16, Line 34)

# APPENDIX B: ACTUAL VS. "INVESTMENT ECONOMICS" PERFORMANCE

**(billions of 1982 dollars)**

NB. This chart presents U.S. actual economic performance from 1985-87 vs. what would have occurred had the nation followed an "investment economics" that would have seen GNP grow 3%, consumption grow 2%, and the difference allocated between nonresidential fixed investment and trade deficit reduction. (This example assumes government spending remained constant during this period.) Ideally, the National Investment Commission would use the broader measure of productive investment outlined in Appendix A; a traditional measure is used below for illustrative purposes.

### Actual vs. "Investment Economics": Investment and the Trade Deficit

| | 1985 | 1986 | 1987 | 1985-87 |
|---|---|---|---|---|
| Actual investment (NFI*) change | --- | -20.4 | 12.0 | -8.5 |
| "Investment Economics" — investment change (NFI*) | --- | +30.8 | +31.9 | +62.7 |
| Actual trade deficit | -104.3 | -137.5 | -128.9 | -24.6 |
| "Investment Economics" Trade Deficit | -104.3 | -73.5 | -41.6 | +62.7 |

### Actual Economic Performance

| | | | |
|---|---|---|---|
| GNP | 3618.7 | 3721.7 | 3847.0 |
| Consumption | 2354.8 | 2455.2 | 2521.0 |
| Investment (NFI*) | 453.5 | 433.1 | 445.1 |

### "Investment Economics" Performance

| | | | |
|---|---|---|---|
| GNP (+3%) | 3618.7 | 3727.3 | 3839.1 |
| GNP change | --- | 108.6 | 111.8 |
| Consumption (+2%) | 2354.8 | 2401.9 | 2450.0 |
| Consumption change | --- | 47.1 | 48.1 |
| Half difference between GNP and consumption growth | --- | 30.8 | 31.9 |
| Investment (NFI*) | 453.5 | 484.3 | 516.2 |

* Nonresidential fixed investment, often referred to as "plant and equipment."

## APPENDIX C: HISTORICAL U.S. SAVINGS AND INVESTMENT DATA
(as a share of GNP)

| | National Saving(1) | Gross Priv. Dom. Invest.(2) | Net Foreign Investment(3) | Net Priv. Dom. Invest.(4) | Net Nonres. Fixed Invest.(5) |
|---|---|---|---|---|---|
| 1951 | 10.1% | 18.1% | 0.3% | 10.0% | 3.5% |
| 1952 | 7.0 | 15.2 | 0.2 | 6.9 | 2.9 |
| 1953 | 5.7 | 14.8 | -0.3 | 6.4 | 3.2 |
| 1954 | 5.1 | 14.5 | 0.1 | 5.8 | 2.7 |
| 1955 | 8.6 | 17.2 | 0.1 | 8.7 | 3.2 |
| 1956 | 9.3 | 17.0 | 0.7 | 8.1 | 3.6 |
| 1957 | 8.0 | 15.8 | 1.1 | 6.6 | 3.5 |
| 1958 | 4.6 | 13.9 | 0.2 | 4.6 | 2.1 |
| 1959 | 7.2 | 16.2 | -0.2 | 7.2 | 2.4 |
| 1960 | 7.2 | 15.2 | 0.6 | 6.2 | 2.6 |
| 1961 | 6.3 | 14.4 | 0.8 | 5.5 | 2.2 |
| 1962 | 7.3 | 15.2 | 0.7 | 6.6 | 2.6 |
| 1963 | 7.8 | 15.3 | 0.8 | 6.9 | 2.6 |
| 1964 | 8.5 | 15.3 | 1.1 | 7.0 | 3.1 |
| 1965 | 9.7 | 16.5 | 0.9 | 8.3 | 4.2 |
| 1966 | 9.3 | 16.6 | 0.5 | 8.6 | 4.6 |
| 1967 | 7.9 | 15.4 | 0.4 | 7.1 | 4.0 |
| 1968 | 7.7 | 15.3 | 0.2 | 7.1 | 3.8 |
| 1969 | 8.3 | 15.9 | 0.2 | 7.4 | 4.1 |
| 1970 | 6.5 | 14.6 | 0.5 | 5.9 | 3.6 |
| 1971 | 6.7 | 15.6 | 0.1 | 6.8 | 3.1 |
| 1972 | 7.7 | 16.6 | -0.2 | 7.8 | 3.3 |
| 1973 | 10.1 | 17.6 | 0.6 | 8.9 | 4.1 |
| 1974 | 7.4 | 16.3 | 0.4 | 7.0 | 3.8 |
| 1975 | 4.6 | 13.7 | 1.4 | 3.6 | 2.3 |
| 1976 | 5.6 | 15.6 | 0.5 | 5.5 | 2.3 |
| 1977 | 6.6 | 17.3 | -0.4 | 7.2 | 2.9 |
| 1978 | 7.9 | 18.5 | -0.4 | 8.3 | 3.6 |
| 1979 | 7.7 | 18.1 | 0.1 | 7.5 | 3.9 |
| 1980 | 5.0 | 16.0 | 0.5 | 4.9 | 3.2 |
| 1981 | 5.5 | 16.9 | 0.3 | 5.5 | 3.2 |
| 1982 | 1.8 | 14.1 | -0.0 | 2.0 | 2.1 |
| 1983 | 1.8 | 14.7 | -1.0 | 3.1 | 1.3 |
| 1984 | 3.9 | 17.6 | -2.4 | 6.6 | 2.4 |
| 1985 | 2.3 | 16.1 | -2.8 | 5.1 | 2.6 |
| 1986 | 1.7 | 15.7 | -3.4 | 5.0 | 1.8 |
| 1987 | 2.0 | 15.9 | -3.5 | 5.2 | 1.7 |

## Annual Averages

| | National Saving | Gross Priv. Dom. Invest. | Net Foreign Investment | Net Priv. Dom. Invest. | Net Nonres. Fixed Invest. |
|---|---|---|---|---|---|
| 1951-60 | 7.3% | 15.8% | 0.3% | 7.0% | 3.0% |
| 1961-70 | 7.9 | 15.4 | 0.6 | 7.0 | 3.5 |
| 1971-80 | 6.9 | 16.5 | 0.3 | 6.8 | 3.2 |
| 1981-87 | 2.7 | 15.8 | -1.8 | 4.6 | 2.2 |

## Sources

1) National Saving - Data from "Why is the US National Saving Rate So Low?" by Lawrence H. Summers and Chris Carroll, November 1987. Based on the authors' calculations for full-employment GNP.

2) Gross Private Domestic Investment - Calculated in current dollars. (U.S. National Income and Product Accounts, Table 5.2, Line 1)

3) Net Foreign Investment - Calculated in current dollars. (U.S. National Income and Product Accounts, Table 5.1, Line 16)

4) Net Private Domestic Investment - Calculated in current dollars. (U.S. National Income and Product Accounts, Table 5.2, Line 3)

5) Net Nonresidential Fixed Investment - Calculated in current dollars. (U.S. National Income and Product Accounts, Table 5.2, Line 9)

# Notes

[1] "U.S. Competitiveness: Beyond the Trade Deficit," by George N. Hatsopoulos, Paul R. Krugman, and Lawrence H. Summers, *Science*, July, 1988, p.299.

[2] Numerous governors, for example - such as Richard Riley in South Carolina, Lamar Alexander in Tennessee, William Winters in Mississippi and William Clinton in Arkansas - successfully waged campaigns to increase public expenditures on education, even as Federal-level spending was being cut back in this area.

[3] Quotation from Robert Solow, in interview with **Rebuild America**.

[4] From speech by Lawrence Summers at **Rebuild America** conference, February 25, 1988.

[5] "Dukakis, Bush Duel on Science-Policy Promises as Scientists Fret Over Funding, Focus of Research," *The Wall Street Journal*, August 9, 1988.

[6] "How To Clean Up Superfund's Act," by Amal Kumar Naj, *The Wall Street Journal*, September 15, 1988.

[7] "S&Ls $3.8 Billion 1st-Quarter Loss Is Half of Deficit for All Last Year," *Washington Post*, June 22, 1988.

[8] *New York Times* Editorial, September 22, 1988.

[9] Hatsopoulos, et al, *op. cit.*, p. 300.

[10] Please see the discussion of America's tendency to blame foreigners in "The Economics of Illusion and the Illusion of Economics," by Robert Reich, in *Foreign Affairs*, Spring, 1987, pp. 517-523

[11] "Why Is The National Savings Rate So Low?," by Lawrence Summers and Chris Carroll, Harvard Institute of Economic Research, November 1987, p. 3.

[12] Net private domestic investment, please see "The Economic Black Hole" by Lester C. Thurow and Laura D'Andrea Tyson, in *Foreign Policy*, Summer 1987, p. 7.

[13] *Science and Engineering Indicators - 1987*, National Science Board 1987, p. 237.

[14] Hatsopoulos, et al, *op. cit.*, p. 303.

[15] See Hatsopoulos, et al., Reich, Thurow and Tyson, *op. cit.*

[16] *Ibid.*, p. 300.

[17] *Ibid.*, p. 301.

[18] *Ibid.*, p. 300.

[19] Thurow and Tyson, *op. cit.*, p. 7.

[20] "Comparative Real Gross Domestic Product, Real GDP Per Capita, and Real GDP Per Employed Person: Thirteen Countries, 1950-1987," unpublished data, Bureau of Labor Statistics, p. 17.

[21] Hatsopoulos, et al, *op. cit.*, p. 301.

[22] *Ibid.*, p. 303.

[23] *Ibid.*, p. 302.

[24] Reich, *op. cit.*, p. 526.

[25] See Lester Thurow, *The Zero-Sum Society*, pp. 183-187, and Pat Choate, *The High-Flex Society*, p. 7.

[26] Choate, *The High-Flex Society*, pp. 7-8.

[27] *Fragile Foundations: A Report on America's Public Works*, National Council on Public Works Improvement, p. 2, February 1988.

[28] The average net savings rate (net savings as a percentage of GDP) of Great Britain, France, West Germany, Italy, and France is was 10.8% in 1986. Data from OECD *Historical Statistics, 1961-1986*, page 69.

[29] Figures for nonresidential fixed investment are used in this illustration rather than "productive investment" as defined on p. 3.

[30] Lester Thurow, *The Zero-Sum Solution*, pp. 116-117.

[31] Summers and Carroll, *op. cit.*

[32] Lawrence Summers, "A Few Good Taxes," in *The New Republic*, November 30, 1987.

[33] Choate, *The High-Flex Society*, pp. 102-106.

# U.S. SAVINGS BONDS AND INVESTMENT TRUST FUNDS

## A Rebuild America Background Paper

**Introduction**

**I. The Use of Low-Denomination Bonds**

- A. The U.S. Savings Bond Program
    - Before and During World War II
    - After World War II
- B. State and Local Usage of Low-Denomination Bonds
    - Background
    - Selected Minibond Offerings
    - Massachusetts Education Minibond Proposal

**II. Investment Trust Funds**

- A. The Social Security Trust Fund
- B. The Federal Highway Trust Fund
- C. Recent Proposals For Investing Social Security Surpluses
    - Robert Reischauer - Higher Education Loan Program
    - George Brown - National Retirement Account Bank
    - Isabel Sawhill: Investing the Social Security Surplus
- D. Other Recent Investment Proposals
    - Michael Dukakis - Student Education
    - Pat Choate - National Public Works Financing Bank
    - Jesse Jackson - Infrastructure Investment
    - David Rosen and David Schwartz - Housing Investment
    - Miscellaneous

# U.S. SAVING BONDS AND INVESTMENT TRUST FUNDS

### A Rebuild America Background Paper

## INTRODUCTION

There is a growing consensus that America will need to dramatically increase both its rate of saving and productive investment in the 1990s.

Two sets of proposals to increase savings and investment have been generating increasing attention in recent years:

(1) the potential importance of beginning a national campaign to issue low-denomination savings bonds to help raise the private savings rate; and

(2) the need for targeted funds to increase investment in such areas as economic development, education, infrastructure and housing.

This paper is meant to serve as background to this discussion.

The first part is a history of national, state and local experience in issuing low-denomination bonds. It indicates that the issuance of low-denomination bonds can encourage individuals to increase their savings and generate revenues for investment in America's future.

The second section is an overview of two existing trust funds - Social Security and the Highway Trust - and recent proposals to create new ones, targeted for investment in such key areas of national need as economic development, education, infrastructure and housing. The report suggests that while there is little movement at this point to implement such proposals, they could move to the top of the nation's policy agenda in the event of a future economic downturn.

One obvious implication of this discussion is that it might make sense to consider *targeting* the revenues from low-denomination bonds to areas of economic need. The primary argument for doing so is that the public is more likely to support a campaign to purchase low-denomination bonds if they are assured that the proceeds will be invested productively. Public opinion surveys reveal that Americans understand the need to invest in strategic areas like nondefense R&D, education, childcare, and infrastructure.

This paper is meant to inform this larger question, which *Rebuild America* plans to specifically address in coming months.

## I. THE USE OF LOW-DENOMINATION BONDS

### A. The U.S. Savings Bond Program *

> **"It is...the story of thousands of patriotic American volunteers who made the program succeed. These volunteers did not ask what their government could do for them -- they did what they could for their government. Never question the fact that when the "chips are down" and this country is in danger, the people of the United States will do their part in any worthwhile government program, if responsible leaders tell them what they want done."**
>
> -- Preface, *The War Bond Story*

The U.S. Government has used low-denomination bonds to involve Americans in the financing of national projects since World War I, when it launched its Liberty Bond program. Although a massive organizational effort involving more than 100,000 War Savings Societies (or Committees) with close to 6 million members was undertaken between 1917 and 1919, the program died out after adopting "hard-sell" promotional techniques.

The most successful and well-known example of the Federal Government's use of low-denomination bonds is the still-operating U.S. Savings Bonds program - a 47-year-old financial instrument which in 1986 and again in 1987 broke post-war records for citizen participation. At yearend 1988, Americans held $109.6 billion in U.S. Savings Bonds.

U.S. Savings Bonds - Before and During World War II

The U.S. Savings Bond program was signed into law by President Franklin D. Roosevelt on February 4, 1935. It was the brainchild of Treasury Secretary Henry Morgenthau, Jr. who had "observed the success of both Great Britain and France in offering, for continuous sale, a government security specifically patterned to the needs of the ordinary citizen."

According to Larry Olney, who served as administrative and personnel director in the early days of the War Bond effort, a huge $4.8 billion appropriation bill addressing the high unemployment rate was pending and there was concern at the Treasury Department about the new securities being held by only a few buyers - banks and wealthy individuals. They believed that "widespread holding of the national debt was a sound principle of government financing."

The specific objectives of the Savings Bond program were:

"1) to instill into the minds of the American people the habit of thrift,
2) to educate the people with respect to government securities,
3) to bind the people closer to their government, not only in financial affairs, but for its total well-being - a Savings Bond was 'A Share of America.'" (Olney, *The War Bond Story*, Chapter 1)

---

* Much of this discussion on the history of the U.S. Savings Bond comes from material provided by the U.S. Savings Bonds Division of the Department of Treasury. This includes "A History of the United States Savings Bond Program," (booklet published by the Division in September 1984); miscellaneous flyers and issues of their quarterly newsletter, *Communicator's Quarterly*; and most of all, two internally produced books on the War Bond effort written by key players in the effort!

In the six years before the Japanese attacked Pearl Harbor, the Savings Bond program brought in almost $4 billion. This was considered quite respectable because there were only 200 employees, no field force, and no sales agencies except the U.S. Post Offices. The Savings Bond Division used direct mail as the primary means of promotion, supplemented with a paid advertising campaign in 19 magazines. Americans viewed them as a secure savings instrument during a period of high bank failures.

However, Treasury Secretary Morgenthau was not pleased with the fact that over 57% of the 17.5 million bonds sold were in large denominations ($100, $500, and $1000) and therefore not reaching the small investor.

As the war heated up in Europe, the Treasury Department had begun developing a defense program using the U.S. Savings Bonds, and by mid-April 1941 Defense Bonds (Series E, F, and G) were being shipped to post offices and Federal Reserve Banks. Defense stamps in denominations of 10 cents, 25 cents, 50 cents, $1.00, and $5.00 were shipped to all post offices as well. Two methods of installment buying - payroll savings and stamps to be collected and turned in for a bond - were decided upon early on, and 40 sales and public relations specialists were hired to promote the bonds. An extensive field organization, centering around the states - was developed, with the Governors of each state serving as Honorary Chairmen. (Olney, Chapters 2 and 3)

A top priority was securing individual banks as Issuing Agents, and this was done with the active support of the American Bankers Association. According to Olney, banks - in the aftermath of the Great Depression - understood:

"1) That by active cooperation in the program they would perform a worthwhile service to the government and to their customers, thereby creating good will and a better understanding of their role as bankers,

"2) That the Defense Bonds were a stabilizing and strengthening factor in the economy of the country and represented reserve purchasing power,

"3) That the bonds would contribute importantly to the sound management of the Public Debt and to the strengthening of the national economy. They would be an important tool in the fight against inflation.

"4) That the program would be a direct method of participating in the creation of the economic climate in which they do business, locally and nationally, and an opportunity to publicly reaffirm their position as patriotic responsible business citizens." (Olney, Chapter 3)

The Federal Reserve Banks issued Defense Bonds to banks and post offices who in turn issued them to purchasers.

On April 30, 1941, Treasury Secretary Morgenthau and President Franklin D. Roosevelt addressed the nation on radio. Morgenthau began:

> *"Tomorrow morning the government of the United States provides one answer to the question that patriotic Americans have been asking ever since the national defense program was undertaken. The question has been: 'What can I do to help?' As the Defense Savings Bonds and Stamps go on sale tomorrow in every state and county, city and town in America, it will be possible for everyone -*

*literally everyone - to take part in the National Defense effort."*

The President then bought the first Defense Bond calling upon Americans to form a "partnership between all of the people and their government -- entered into to safeguard and perpetuate all those precious freedoms which government guarantees by investing their savings in Defense Bonds." (Olney, pg 15)

That same day, Sylvia Porter, a leading national financial writer, called the event "launching the greatest money-raising drive in the history of the nation and perhaps of the world." (Olney, page 16) Americans purchased over $100 million of Defense Bonds that day.

Between May and early December, all states but two had been officially organized and the other two did so immediately after Pearl Harbor.

Three Treasury Houses were opened in Washington, New York, and Boston and served as information centers for the Defense Bond program. These Houses were used to broadcast hourly radio reports, hold concerts, and exhibit military hardware.

The motion picture industry, including many leading stars, also played an important role during 1941 to promote defense bonds, developing special clips and distributing them to theatres across the country.

One of America's leading radio advertising specialists joined the Treasury Department staff as Director of Radio, Press and Advertising, and worked closely with the Advertising Council which was founded by the advertising industry to support significant national projects like the Defense Bond program (which was its first account). "The Advertising Council, through the cooperation of the American Association of Advertising Agencies, appointed leading advertising agencies of the nation to serve as a task force for the bond program. They divided the assignments, one taking general newspaper and general magazine advertising, another industrial magazines, another farm publications, and so on. This also applied to radio, outdoor and transit advertising." (Olney, page 23)

Major promotional efforts included:

- **Payroll savings program** - A top priority was implementing a payroll savings program, modeled after successful employee stock ownership programs run by innovative American corporations. Olney estimates that by Pearl Harbor, over 700,000 U.S. workers were participating in the payroll savings plan and this increased to 26 million workers by early 1943. AT&T was the first large U.S. company to sell bonds to its workers and did so well before the defense effort began.

- **"School-At-War" program** - This program which involved schoolchildren purchasing Defense Stamps and ultimately, bonds "was primarily educational -- preservation of democracy, good citizenship and financial support of...government" and had as its purpose "to enlist the schools, administrators, teachers and pupils, and through the latter to their parents and the community, in the bond program." In 1941, 50 million stamp albums were distributed across the country. (Olney, page 20)

- **Newspaper carrier boys savings stamp program** - Initiated by the *Philadelphia Evening Bulletin* in the fall of 1941, within a few months, this program involved over 900 newspapers and more than 150,000 carrier boys actively selling stamps.

- **Farmers** - Because the payroll savings program did not reach the agricultural sector, a specific promotion calling upon farmers to combine their patriotic duty with a build up of their financial reserves for emergency and modernization purposes was developed and successfully implemented.

- **Retailers** - America's retailers were called upon to assist in the publicity of Defense Bonds. According to Olney, "retailers featured bonds in their newspaper advertising and through window displays. Many retail stores assumed a quota of a certain per cent of bond and stamp sales in relation to their total trade volume, using as a slogan, "Take part of your change in Defense Stamps." (Olney, page 22)

- **Other** - Special promotional efforts were developed to utilize networks of women, blacks, labor unions, fraternal and civic organizations, trade and business associations, and immigrants to increase the sale of Defense Bonds.

From May 1st through the end of 1941, sales of Defense Bonds and Stamps totalled nearly $1.8 billion with expenses connected with their promotion and sale totalling only $1.6 million. This was made possible by the volunteer efforts on the part of all Americans - corporations, retailers, farmers, the advertising and motion picture industries, citizens, schoolchildren.

After the attack on Pearl Harbor, Defense Bond sales skyrocketed with the New York Federal Reserve Bank reporting an 800% increase in demand, and the Federal Home Loan Bank Board indicating a 276% increase for the week December 8-13th, 1941. (Olney, page 30)

President Roosevelt's January 1942 budget called for $59 billion in total government spending, with nearly $53 billion earmarked for the war effort. Even after raising taxes significantly, the government had to borrow $48 billion and planned to raise 25% through the sale of U.S. savings bonds. Meanwhile national income increased from about $77 billion in 1940 to an estimated $115 billion in 1942. Alternative Congressional proposals to curb inflation included an "enforced savings plan" and a general sales tax, but Treasury Secretary Morgenthau felt strongly that the effort should be voluntary.

In the first months of 1942, a bulletin called "Sharing America" prepared in conjunction with the U.S. Office of Education was distributed to every educational institution to "enlist 25 million school children in the Defense Savings program." (Olney, page 29)

Also in early 1942, a pledge campaign was initiated involving house-to-house canvassing by volunteers, the establishment of state committees to oversee the payroll savings plan, an extensive promotion campaign, and "an educational drive, through all mediums of public expression to teach the importance of saving, whether through Defense Bonds or any other means -- just so long as it's saving." (Olney, page 41)

After Pearl Harbor, celebrities were used more frequently to promote the sales of War Bonds and in late August 1942 the "Stars Over America" War Bond Tours were launched at a rally on the Treasury steps. According to Olney, over 40 stars were "divided into seven groups and assigned to the tours which visited 353 cities and towns during the month of September. Appearances were not at theatres but at public mass meetings, bond luncheons, dinners and factories...War Bond sales reported in connection with the star's visits totaled in the hundreds of millions of dollars. The grand climax...came on September 30, 1942, when in New York City's Madison Square Garden, stars from all of the tours gathered together to stage what was one of the largest and most spectacular bond rally and patriotic event of its kind ever held. The program was broadcast over nation-wide radio networks to an audience of many millions." (Olney, pages 45-46)

In mid-1942, the Treasury Department began to give states and counties War Bond quotas which was difficult due to variations among the states. According to Olney, in late April 1942, the Treasury Department announced its objectives: "to obtain 10 per cent of the national pay check in bonds with a country-wide quota of 600 million dollars in May, 800 million in June and hitting the billion dollar figure in July. The principal method of achieving these goals was through the 10 per cent payroll savings plan." (Olney, page 43) Although the quota was met in May, bond sales fell short in June and July teaching the War Bond Department that three-month campaigns were too long to hold the public's attention.

Late in the year, the First War Bond Drive was held and in 23 days, raised almost $13 billion, greatly exceeding the goal of $9 billion. Some were disappointed with the results because only a small percentage were the Series E low denomination bonds, but the War Bond Office achieved its goal of securing 30 million payroll savings workers.

A November 1942 national survey revealed that 80% of all American adults had purchased either War Bonds or Stamps. By early 1943, 26 million American workers were participating in the Payroll Savings Plan buying $400 million worth of War Bonds monthly.

By the beginning of 1943, the U.S. government was spending over $200 million daily on the war, and by the end of June 1943 the public debt was more than $135 billion, up from $48 billion in June 1941. As of February 1943, close to 50 million Americans owned war bonds.

By this time, the threat of inflation was so great the promotional material emphasized "Dangerous Dollars." A 1943 pamphlet put together for labor and management read in part:

> "We must protect ourselves against 'Dangerous Dollars.' In 1943 there will be 45 billions in the hands of the American people over and above the amount of consumers' goods available to them. These are 'Dangerous Dollars' burning holes in people's pockets. If we try to spend these 'Dangerous Dollars' we will -- force up prices -- encourage black markets -- and open the door to inflation. The people who have this money must be induced to save by lending it to the Government in the form of War Bonds...OUR JOB IS TO get every dollar beyond what is actually needed for living expenses -- to get the people to understand why real sacrifice -- giving up luxuries and unnecessary spending -- is expected of them." (Olney, pages 60-61)

The slogan of the Fourth War Loan Drive, which took place in early 1944, was "Let's all back the Attack," and according to Olney, the theme was "Sacrifice, Everyone to buy extra bonds." The promotional material explicitly discussed the responsibilities of all citizens and included a statement that "To deny yourself that investment today is to miss the opportunity for guaranteeing the future security of your family, your children, your country." (Olney, pages 77-78)

From May 1941 until the end of the war, eight loan drives were held in all, each lasting about a month and spaced an average of four months apart. By the end, the total effort resulted in individuals increasing their holdings of U.S. savings bonds by $42.7 billion, and low-denomination bonds (Series E) by $33.7 billion. Between May 1941 and December 1945, the total sale of War Savings stamps was $1.7 billion primarily through the school and newspaper carrier programs. According to Olney, "the impact of the thrift message on youngsters who were growing up to be future payroll savings and bond-a-month customers was important to the long range bond program." (Olney, page 106)

According to Olney:

> "The purpose of the Series E bond was to democratize public finance in the United States. The objective was to have the ownership of America in the hands of the American people. When war broke out they served not only as a vital factor in financing the rearmament of our fighting forces, but what is even more important, they gave to the average citizen a sense of the war's meaning and of the urgent nature of the national danger. Throughout, the program was conducted on a genuinely voluntary democratic basis...The desire of the people "to help", the sense of participation in the national cause, could never have been realized except through a voluntary program." (Olney, page 105)

Over 6 million Americans were involved in selling War Bonds during World War II.

### U.S. Savings Bonds - After World War II

The U.S. Savings Bonds program has continued since the end of World War II, surprising many who believed that it would end along with the war. As Olney reports:

> "It was widely assumed that the bond program would come to a natural end with the closing out of the wartime emergency which had brought it into being. But the bond-buyers thought otherwise. Having tasted the fruits of regular saving -- many of them for the first time in their lives -- millions of them wanted to go on with their payroll savings for bonds, or regular purchases at the bank. The volunteer corps felt the same way. Business and industry, banks, labor organizations, womens' and veterans' groups of all kinds demonstrated a belief that popular participation in government financing had a place in a peacetime economy as well as under wartime conditions. So the program continued on a less intensive but equally broad-gauged basis making undramatic but steady gains year by year." (page 107)

U.S. Savings Bonds sold "steadily if unspectacularly, until the late-1970s when they reached a second peak in popularity just before bank deregulation and the explosion in inflation and interest rates that marked the years surrounding 1980. The pressures of deregulation and high interest rates led the Treasury Department to revamp Savings Bonds into a thoroughly modern financial product...Since November 1982, Savings Bonds have offered buyers the best of all possible worlds: a security tied to market rates that also boasts a minimum rate." (*Communicator's Quarterly*, Winter 1987-88, page 5)

Savings stamps were discontinued in the 1970s because demand was low and administrative costs were so high making them not cost-effective.

The Savings Bonds Division's advertising budget shrank from $240 million in 1944 to only $100 million in 1987, and the Advertising Council dropped the U.S. Government as a client (although the program still enjoys free advertising services). Despite this, in fiscal year 1986, sales of savings bonds were $8.3 billion - the highest since World War II. In 1987 a new record was set when sales reached $10.3 billion, and at yearend 1988, the total value of bonds outstanding stood at $109.6 billion, the highest total in the history of the bond program and representing 5.9% of the privately held portion of the public debt.

The current head of the National Volunteer Committee is John McGillicuddy, chairman of the board of Manufacturers Hanover. "The Volunteer Committee, formed in 1963, includes members from the highest ranks of the nation's corporate, government and educational leadership. Committee members lead publicity campaigns to sell U.S. Savings Bonds through the Payroll Savings Plan and over-the-counter at banks." (U.S. Savings Bonds Division material) Today 47,571 company units offer the Payroll Savings Plan nationwide.

Several states have continued to strongly support the Savings Bonds Program, including the Commonwealth of Virginia whose 1988 campaign included public service announcements featuring Lieutenant Governor Douglas Wilder around the theme "The Great American Investor - Our Children Are Our Future."

According to two national surveys conducted in late 1987 and early 1988, savings bonds are owned by 28% of all Americans, with the average buyer being 43 years old and earning $38,000. Over 50% of the respondents said they chose to invest in U.S. savings bonds for security and patriotic reasons while about 30% said they did so because of the bonds' competitive rate and about 20% because of the tax advantage. While 60% of those surveyed viewed bonds as a general savings instrument, more than 50% were specifically saving for college expenses or retirement. ("Great American Investors: Profiling the Savings Bonds Buyer," a flyer available from the U.S. Savings Bonds Division of the Department of Treasury )

### B. State and Local Usage of Low-Denomination Bonds

> **"From the local government issuer's perspective, there is one principal benefit associated with minibonds - the positive public relations that such a sale can generate. The advertising and news coverage related to the sale expands the local citizens' awareness of the need for investment in capital resources and gives the public a better understanding of how that investment is financed."**
>
> - From *Municipal Minibonds*, Government Finance Officers Association

#### Background

According to the Government Finance Officers Association, the use of low-denomination bonds ("minibonds") by state and local governments dates back to the 1870s when the City of New Orleans sold $20 denominated bonds. During the 1930s depression, a few other municipalities issued small denomination bonds, and between 1969 and 1974, the City of Philadelphia School District issued $3.145 million of $100 denominated bonds.

In the late 1970s however, the sale of tax-exempt minibonds by state and local governments began to gain widespread media attention, beginning with the City of East Brunswick, New Jersey's sale of $529,000 in $100, $200, and $500 minibonds. The Government Finance Officers Association (GFOA) states that this issue "marked the beginning of an entirely different way for local governments to access the credit markets."

This avenue became increasingly important in the 1980s when huge Federal budget deficits resulted in tax code revisions making it less attractive for institutional buyers to hold municipal tax-exempts. In addition, the GFOA says that because of new restrictions on the acceptable uses of tax-exempt debt, the supply of new tax-exempt paper "plummeted from a record level of issuance in 1985 (over $200 billion) to a 1987 total of slightly under $100 billion." In 1985, institutional purchases of tax-exempt securities were about $60 billion. By 1987, banks, insurance companies and other institutions *sold* $20 billion more tax-exempt securities than they bought. At the same time, households and funds have increased their purchases of such securities, and now buy about $50 billion a year.

Due to these significant changes in the tax-exempt bond market, several states and cities have used minibonds to finance economic development efforts. These include Germantown, Tennessee; Rochester, New York; Bowling Green, Kentucky; Salt River, Arizona; the Southern Minnesota Municipal Power Agency; Fort Worth, Texas; the Commonwealth of Massachusetts; the City of Boston, Massachusetts; Eugene, Oregon; Virginia Beach, Virginia; and Prince George's County, Maryland.

Based on discussions with several finance officers involved in minibond sales, the following points can be made:

1) Minibonds (citizen bonds) permit many more people to invest in tax-exempt securities, thus expanding the municipality's financing base. Typically, minibonds have been issued in $100 denominations compared to the $5,000 minimum investment usually required for tax-exempt municipal bonds.

2) Almost all issues were oversubscribed (they could have sold more) indicating strong community support. Investors must have faith in the issuer, and like having the opportunity to directly invest in their own community.

3) Positive public relations is the greatest benefit to issuers of minibonds.

4) The primary opposition to minibonds is from brokers who lose out on commissions.

Several other municipalities currently are planning issues of minibonds, and the Government Finance Officers Association has recently published a handbook advising finance officers on all aspects of such issuances. In addition, they have developed computer software to "allow state and local finance officials to perform all aspects of a municipal minibond sale, including paying agent and registration functions."

Selected Minibond Offerings

**East Brunswick, NJ** - East Brunswick is an upper-middle class suburb with a lot of community pride. In 1979, there were two bond issues for a public works facility about which there was considerable community interest. Both sales were oversubscribed. Citizens enjoyed owning a piece of the facility (there is absolutely no vandalism), and were pleased that they were provided an honest tax break. The bonds were sold in denominations of $100, allowing just about anyone who was interested to participate. Each issue was $600,000 and there was no limit per investor.

**Commonwealth of Massachusetts** - Massachusetts has issued "citizen bonds" or "minibonds" 15 times with a total volume of $175 million since 1979. The $100, $500 and $1000 bonds which are sold twice a year are general obligation bonds and in the past have financed heavy equipment and computer equipment purchases among other capital investments.

**Germantown, Tennessee** - Germantown is an affluent city with a population of 30,000. In 1985, when the community became interested in constructing a civic center, $2 million worth of minibonds were issued in $500 denominations. 35% of the schoolchildren were going to be in college 10-15 years hence, so the tax-exempt bonds were targetted to some extent at their parents as a good investment. There was a $25,000 limit per person, and the average ticket was $11,000. 168 people bought bonds. The bonds were sold out within four days, after running only one ad in the newspapers (four other ads had been prepared). The ads were non-technical - "You give us so much money, we'll give you back so much money." Hal Canary, the chief finance officer, estimates that half the investors had never bought municipal bonds before. Although there was a lot of publicity about the civic center at the time, the "Citizen Bond" proceeds were not directly tied to the civic center. Proximity to Memphis helped expand the size of the market. Germantown itself had an excellent financial reputation.

**Rochester, NY** - The purposes of the Rochester mini-bond initiative were to raise short-term capital and make people aware of the vitality of the city. Considerable thought and energy went into the marketing of the bonds ("Buy a piece of the Roch!"). The first issue was $500,000, and available to small investors for $500. The second was about $350,000, and issued in conjunction with the city's 150th anniversary in denominations of $100. One idea was to make the notes in the second issue nice enough to frame in hopes that people would save them instead of cashing them in. (This wasn't successful.) Individual investors were limited to $20,000. Ads were placed in the paper displaying taxable yields versus tax-exempts with lines like: "If your income is such, your tax-exempt yield would be..." Both issues were oversubscribed. The average purchase was $2,500 and there were definitely many new investors.

**Fort Worth, Texas** - In July 1987, Forth Worth offered $1.7 million worth of minibonds which sold out in four days. According to the Government Finance Officers Association, the bonds were structured as zero-coupon bonds and sold at a discount of the $1000 face value and have a variety of maturities ranging from 1990 through 2006. The success of this first issue has resulted in plans to do further issuances of minibonds in the future.

**Virginia Beach, Virginia** - In April 1988, the City of Virginia Beach became the first municipality in Virginia to utilize minibonds issuing $2 million worth of capital appreciation bonds maturing in May 1991. The bond denomination was $500 and there was a $5000 limit on what individual investors could purchase. The city organized an extensive marketing campaign combining the resources of the finance department, the office of public information, and elected officials, and utilizing contacts with the local television stations and print media. The city also used a "hotline" to respond to inquiries a month prior to and during the subscription period. The $2 million issue sold out in one week, and according to the Government Finance Officers Association was "an unqualified success" having "achieved the primary objectives of making the city's debt available to a wider audience and expanding local awareness about Virginia Beach's capital investment process."

**Prince George's County, Maryland** - In January 1989, Prince George's County sold $1 million worth of capital appreciation bonds in $500 denominations. Individual investors were limited to 10 minibonds. The bonds - which will mature in 1992 - were scheduled to be sold during a two-week subscription period, but because of the publicity in the local papers sold out on the very first day.

**Montgomery County, Maryland** - For the first time, Montgomery County is going to offer minibonds, with the proceeds to be earmarked for affordable housing - addressing a critical problem in the county. The bonds will be available in $100 and $500 denominations to Montgomery County residents only, and a $5000 limit will be imposed.

Massachusetts Education Minibond Proposal

In March 1988, Governor Michael Dukakis proposed an innovative educational financing scheme that involved the sale of low-denomination general obligation bonds whose return was tied to college tuition costs. The Massachusetts legislature is currently considering a variation of the proposal.

The explicit purposes of the program are "to provide families with a structured way to save for higher education, to increase the rate of savings for higher education, to promote the habit of savings for higher education, to provide tax incentives for saving for higher education, to provide a guaranteed rate of return that will insure the affordability of higher education in the Commonwealth, and to preserve the competitiveness of the Commonwealth's higher education industry." ("College Opportunity Fund," Massachusetts Education Loan Authority paper)

Bond denominations will begin at $50 to encourage parents and others to save on a regular basis. Accounts can be established for the beneficiary with designated amounts deducted electronically from the purchaser's paycheck or checking account. It will also be possible to buy bonds as one-time gifts. Each year, the beneficiary will receive a statement indicating the percentage of tuition it is currently worth at each participating institution. The beneficiary can present the statement to any participating institution as tuition payment.

Risk is shared by the state which provides a "general tuition guarantee" to ensure that the purchasers' investment does not lose its purchasing power, and participating institutions which provide "institutional specific tuition guarantees" to guarantee the yield to the extent that their tuitions rose more than the state average.

The program has been designed to easily offer reciprocity with other states implementing similar programs.

Sources: *Municipal Minibonds: Small Denomination Direct Issuances by State and Local Governments*, by Lawrence Pierce, Percy R. Aguila, Jr. and John E. Petersen; discussions with several government finance officers; and background material prepared by the Massachusetts Education Loan Authority.

## II. INVESTMENT TRUST FUNDS

Several proposals have been put forth in recent months to link new federal revenues to particular spending programs, and to create new trust funds to insure a certain level of spending despite huge budget deficits. While these proposals are not yet under serious consideration by the Congress or Administration, they could move to the top of the nation's policy agenda in the face of an economic downturn.

Federal trust funds are not a new concept. There are 14 categories of trust funds In the FY 1989 budget, comprising about 28% of total federal spending. Besides social security and medicare, these involve military and civilian retirement, unemployment compensation, highway construction and maintenance, and airport improvements and airline safety. The Congressional Budget Office estimates that in 1989 seven of the largest trust funds will have combined surpluses of over $115 billion, thereby obscuring the true magnitude of the federal budget deficit.

Perhaps the best known examples of federal trust funds are the Social Security system with its Social Security Trust Fund capitalized through employee payroll taxes, and the federal-aid highway programs financed through the Federal Highway Trust Fund and primarily motor fuels taxes. It is interesting to examine the history of these programs.

### A. The Social Security Trust Fund

[N.B. Much of the following discussion comes from Dutch Leonard's *Checks Unbalanced: The Quiet Side of Public Spending*, (Basic Books, 1986) Readers are encouraged to examine this sobering account of America's unfunded liabilities.]

The Social Security system was developed largely as a result of widespread public concern about poverty among American seniors - a situation greatly exacerbated by the Great Depression.

The Social Security Act of 1935 was signed into law after considerable debate about whether the social insurance system should be fully-funded or operated on a "pay-as-you-go" basis. Many people feared the large trust fund surpluses that would accumulate if the program was fully-funded; indeed the 1980 projected surplus of $50 billion was close to the size of the entire economy at the time of the debate. Others, including Treasury Secretary Henry Morgenthau, Jr. who served on the Cabinet-level committee developing the proposal to "give some protection to the average citizen and to his family against the loss of a job and against poverty-ridden old age," believed strongly that "each generation of participants pay for its own benefits...[making the system] solvent not only on an operating basis...but also on a shutdown basis." (Leonard, p 53)

After the Committee on Economic Security came up with a compromise proposal with many "pay-as-you-go" characteristics, President Roosevelt expressed his disapproval stating "It is almost dishonest to build up an accumulated deficit for the Congress of the United States to meet in 1980. We can't do that. We can't sell the United States short in 1980 any more than in 1935." (Leonard, p 54) An amendment was put forth by Morgenthau that moved the system to an almost-fully-funded basis, and after much Congressional debate, the Social Security Act was passed.

The 1936 presidential campaign between Roosevelt and Alfred M. Landon focused on the new social insurance system, and particularly, the new payroll taxes being implemented to fund it. Roosevelt's resounding victory in November 1936 reflected in large part the public's widespread support for his social security program.

According to Herman B. Leonard, a Harvard public finance expert, the remaining issues were constitutional. "The constitutionality of the Social Security Act depended on the Supreme Court's interpretation of the relationship between the taxing part (Title VIII) and the old-age-benefit part (Title II). Title II could be sustained under the authority of the federal government to spend money to promote the general welfare. But the federal government had no apparent authority to link the two. To avoid infringing on the state's powers, the taxing part and the old-age-benefit part had to remain entirely separate. They did; the sections had been carefully drafted so as not to refer to each other...[The Supreme] Court found all of the Social Security Act titles constitutional. The payroll tax was just a tax, paid into an account at the Treasury. No funds were appropriated by the act. And the old-age title, which never mentioned "insurance," clearly supported the general welfare in the way other "gratuitous" transfers might. So the Court found." (Leonard, p 55)

Leonard continues:

> "The Court's view was fundamentally at odds with every aspect of the program's design as expressed in the Perkins committee report, the legislative history, and

> popular discussion. The designers of the system clearly intended that its payroll taxes be so synonymous in the minds of contributors with old-age benefits that no Congress could ever divert them to any other purpose. But that logic was political, not legal, and the Court was bound only by what it found in the law. The constitutionality of the act was upheld on the grounds that, as written, it was not a mandatory public insurance program - which, of course, was exactly what it was and what it absolutely had to be to survive politically. To the Court, it was just a tax program and a welfare program financed out of general tax revenues." (Leonard, p 55)

The original Act did not provide for benefits to be paid until 1942, and by the end of 1939, the Trust Fund had built a surplus of $1.7 billion. Conservative members of Congress began to worry more about the accumulation of reserves than preserving the Social Security system as a fully-funded program. After considerable debate in 1939, the U.S. Congress adopted amendments to the Social Security Act based on a proposal put forth by President Roosevelt to expand the system - increase benefits, add benefits for survivors of participants, and begin paying benefits earlier than originally scheduled. Additionally, Congress rebased the benefits calculation on average monthly earnings rather than on what each recipient had actually contributed.

According to Leonard,

> "[T]he amendments of 1939 adopted a funding orientation that started an intergenerational transfer on a grand scale and set a precedent that , once established, would become practically inescapable for those who followed...The social security system entered 1940, the year of its first benefit payments, sheltered by a political fortress. The cornerstone was the widespread notion that the system was directly contributory - that an individual's payroll taxes flowed into his or her personal account, accumulated interest, and would be paid back. This interpretation was explicitly ruled out by the Court's statement of the constitutional basis of the program. It had been rejected as a funding philosophy by the system's staff and by Congress. Moreover, it was inconsistent with the economics of the system's actual financing.
>
> "But the notion persisted - indeed, it was explicitly promoted - because it played a crucial role in the long-term political impregnability of the system. Roosevelt emphasized from the outset that the system had to be financed by payroll taxes, referred to as contributions. If it was supported by general revenues, it was a gift that could be cut. Contributions were owned by and owed to the contributor. Roosevelt patiently explained this over and over: 'Those taxes were never a problem of economics. They were politics all the way through. We put those payroll contributions there so as to give the contributors a legal, moral, and political right to collect their pensions and their unemployment benefits.'" (Leonard, p. 57)

Between 1939 and the early 1970s, the Social Security system was expanded significantly as the American economy fared much better than had been originally projected. Coverage was extended to additional workers and benefits were added. In 1972, Congress voted to index benefits to both wage and price increases resulting in the double-counting of inflation, and according to Leonard, leading to the nearly doubling of benefits between 1972 and 1977.

As the U.S. economy faltered in the 1970s, the Social Security system faced a crisis situation and Congress responded with a short-term solution by raising payroll tax rates in 1977 - amounting to the largest peacetime tax increase ever.

Both the Carter and first Reagan administrations began to develop more comprehensive reforms as it became clear that the 1977 adjustments did not address the structural problems in the system, but Congress "categorically rejected both immediate benefit cuts and any proposal that smacked of making social security a welfare program." (Leonard, p 63) It wasn't until the trust funds were threatened with cash insolvency within two years that real reform was enacted. The Reagan administration established a high-visibility bipartisan commission, commonly known as the Greenspan Commission after its Chair Alan Greenspan, which proposed both short and long-term policy options to revamp the Social Security system. Congress enacted the bulk of the commission's proposals addressing both the immediate cashflow crisis and moving toward the fuller funding of the long-term obligations to the baby boom generation.

Huge Social Security surpluses are currently building up and are projected to total as much as $12 trillion in nominal dollars by the year 2032. But because these surpluses are invested in U.S. Treasury securities, they are permitting Congress to spend more than it receives in taxes without explicitly having to borrow from the public, and masking the true size of the Federal budget deficit. It has been estimated that future American workers will have to devote as much as 36% of their taxable pay to cover all of the benefits promised to baby boomers upon their retirement.

Source: Leonard, Herman B. *Checks Unbalanced: The Quiet Side of Public Spending*, (New York: Basic Books, 1986.

### B. The Federal Highway Trust Fund

Although the Federal motor fuels tax was first imposed in 1931, the revenues weren't earmarked for physical infrastructure until President Eisenhower signed the Federal-aid Highway Act into law in 1956 thereby launching the "greatest peacetime public works program in the history of the world." To give a sense of the magnitude of the project, in 1987, the Federal-aid System included 843,000 miles of roads - comprising 22% of the nation's total 3.86 million miles. (TRIP, p 12)

The Federal Highway Trust Fund was created "to provide stable federal financing (mainly through broad-based user fees) for the construction of all federal-aid roads, including the Interstate Highway System." (TRIP, p 12) It was scheduled to be in existence for 15 years at which time the Interstate Highway System was to be complete. Over the years, starting in 1966 with debates over the Safety Acts, additional programs have been financed by the Trust Fund delaying completion of the Interstate network, and the Fund is now scheduled to expire in 1993. Interestingly, 95% of the construction financed through the Federal Highway Trust Fund was in planning within the first ten years of the program.

Due to increased vehicle fuel-efficiency, the Trust Funds dependence on the motor fuels tax declined from 79% in 1959 to 58% in 1980 leading to the major Federal highway bill passed in 1982.

The 1982 Surface Transportation Assistance Act increased highway user taxes and expanded the purposes for which trust fund revenues could be expended to include highway repair, bridge replacement, and mass transit. At the time, the Federal gasoline tax was increased from 4 to 9 cents a gallon, and the Federal tax on diesel fuel rose from 4 to 15 cents per gallon. These hikes together with an increase in the heavy vehicle use tax more than doubled the amount of money available for construction and improvements in the Highway Trust Fund. Other dedicated excise taxes include: a graduated tax on tires over 40 pounds, a 12% fee on new heavy trucks and trailers, and a heavy vehicle use tax on trucks over 55,000 pounds.

In 1987, the Federal government was financing 55 percent of all capital spending (new construction and major rehabilitation) through grants to state highway departments, with 40% of all Federal-aid dollars dedicated to the Interstate System. (TRIP, p 13)

The Road Information Program (TRIP), an industry-sponsored nonprofit organization, estimates the total amount needed for road repairs at $293 billion in 1987 dollars, and assesses the state of the nation's highway system as follows:

"The serious state of the nation's infrastructure is due partly to its age. Of the nation's 3.86 million miles of roads, 3.55 million already were built by 1960. Even most of the national Interstate System was built or under construction by 1966. Roads were expected to last about 20 years, depending on design as well as traffic load, but today many miles of roads have passed or are naring their "design-life." In addition, many of our most important roads have sustained much heavier traffic loads than they were built to withstand. Also, many of America's bridges were designed and built 40 to 50 years ago (or more) and now, reaching the end of their useful lifespans, are growing deficient and obsolete under increasing traffic volumes and weights and fluctuating weather conditions." (TRIP, ps 4-5)

According to TRIP, "the federal highway bill that cleared Congress in 1986 actually authorized some $2 billion less to the states for road and bridge programs annually than did the Surface Transportation Act of 1982. A total of 47 states [in 1987 were] receiving less federal funding from the new bill than they did [in 1986]." ("1987 State Highway Funding Methods," Introduction)

### C. Recent Proposals For Investing Social Security Surpluses

Several investment initiatives involving innovative public financing have been proposed in recent years. A number of these involve using Social Security surpluses to capitalize investment trust funds, while others involve the creation of trust funds financed through increases in other taxes and still others involve the use of federal guarantees and public pension funds. While there is little movement at this point to implement such proposals, they could move to the top of the nation's policy agenda in the event of a future economic downturn.

Currently, large and increasing social security surpluses are being used by Congress to mask the size of the federal deficit. While the overall deficit commonly referred to seems to be declining, this is largely the result of rising social security surpluses which are accumulating at approximately $40 billion a year. As Isabel Sawhill of the Urban Institute points out, this money "is used to pay for everything from MX missiles to the President's salary." This "raiding" of the Social Security Trust Fund - whose cumulative surpluses are estimated to reach more than $12 trillion in nominal dollars by 2032 - has resulted in a number of creative proposals calling upon Congress to instead invest those surpluses in areas that will enhance productivity and lead to future economic growth.

#### Robert Reischauer - Higher Education Loan Program

Under Robert Reischauer's Higher Education Loan Program (HELP) proposal, any student who is in good standing and enrolled more than half time at an accredited institution of higher education would be able to borrow from a new trust fund. The loan arrangement would be solely between the student and the fund, the student's family circumstances would be irrelevant, and borrowers would not have to meet a needs test.

Students who borrow from the trust fund would repay their loans through the existing FICA payroll tax system. Each borrower's payroll tax would be increased, with the size of the increase dependent on the amount the individual borrowed from the trust fund. The increased tax rate would apply only to the employee, not to the employer, portion of the payroll tax. The tax rate, or uniform loan repayment rate, would be set so that each cohort of borrowers would repay the trust fund for the full costs of its loans.

The amount that could be borrowed per percentage point of HELP payroll tax could be indexed to keep pace with the rising cost of education without threatening the financial integrity of the trust fund. Low tax rates are possible under the HELP approach because the burden of repaying student loans would be stretched out over the borrower's full working life. Repayments would start immediately in that the new payroll tax rate would be applied to wages that borrowers earned from part-time or summer jobs while they were in school. Payments would continue to be deducted whenever and wherever the borrower worked.

Reischauer explains that a certain amount of redistribution would occur among borrowers because, per dollar borrowed, the amount repaid by each borrower would be proportional to that individual's lifetime earnings. Those who became disabled, experienced significant periods of unemployment, worked in low-wage jobs or participated in the labor force on a part-time basis might not pay taxes sufficient to cover the full cost of their individual loans. At the other extreme, borrowers who worked continuously in high-wage jobs would contribute more than enough to cover the costs of their loans. However, the degree of redistribution would be limited by the earnings maximum already build into the FICA system.

According to Reischauer, the HELP system would greatly simplify the student loan system and reduce administrative costs. A single program administered by a single agency could replace the four existing federal programs and the myriad of public, private and non-profit institutions now responsible for administering and guaranteeing loans. The complex financial need analysis system could be swept aside for loan recipients. There would be no need for guaranteeing agencies. Defaults and repayment arrears would no longer exist because the correct level of payments woudl automatically be withheld from borrowers' earnings.

He notes that initial capitalization would be necessary, especially in the first two decades. Private capital markets would be one possible source, as they are now lending about $9 billion to students. An alternative would be to invest the social security trust fund surpluses expected to grow to $96-108 billion annually by 1995. The HELP trust fund would pay the social security system the same interest it would have received had it continued to buy federal debt instruments. When the social security system needed its capital back to support the retiring baby boom generation, the HELP trust fund could refinance its portfolio. Phasing out the existing subsidized student loan programs would also reduce federal borrowing requirements by about $3.5 billion.

Reischauer argues that if students of vocational and trade schools were included as well, the degree of cross subsidization could be large enough to make the program unworkable because the lifetime earnings of non-collegiate borrowers is sufficiently low that it would push the tax rate up to a fairly high level.

Source: Reischauer, Robert. "HELP: A Student Loan Program for the 21st Century," October

1987.

George Brown - National Retirement Account Bank

Rep. George Brown (D-CA) proposes that Social Security surpluses be "invested throughout the public and private sectors by a National Retirement Account Bank in stocks and bonds the way state, municipal and private pensions are today. The bank would invest in all types of securities, including both government and private debt and equity."

Currently, the law requires that all federal trust funds be invested only in non-marketable Treasury bonds. Brown points to the huge cumulative surplus of $12 trillion in nominal dollars that the Social Security Administration projects by 2032 and Pete Peterson's estimate that the cost of all Social Security benefits could rise to as much as 36% of every worker's taxable pay when baby boomers retire. "Our children may not be able to pay these taxes unless today's surpluses are invested in ways that increase national productivity growth dramatically."

Brown cites data from the Employee Benefit Research Institute that shows that private trusteed pension funds with assets totalling $1 trillion at yearend 1986 achieved a real rate of return of 13.5% from 1982 through 1986. At the end of 1987 - after the stock market crash - these pension funds still achieved 11.25% real returns. Brown's office calculates that if the Social Security surpluses yielded an 8.5% real return (instead of the 5-6.5% assumed by the SSA), OASDI taxes could be repealed after 2020!

Brown's proposal involves professional portfolio managers investing the surpluses similar to the way they invest state and municipal pension funds already, thereby removing Social Security investments from political influence. Additionally, he notes that a National Retirement Account Bank - in close coordination with the Federal Reserve - would give monetary managers "much more powerful and precise tools for curtailing inflation and recession."

He emphasizes that his proposal would "not involve the Social Security Trust Funds in an orgy of speculation on the stock market. Rather, the investment proposal would reflect the conservative holdings of market indices like the Standard and Poor's 500, the Dow-Jones and the Lehman Cororate-Government bond index. A small percentage, similar to that of private pension funds would be invested in more risky startup ventures in new industries. Some of those investments might take the form of reinsurance for Small Business Investment Corporations thus providing the off-budget quasi-governmental loan guarantees to broaden secondary securities markets in new businesses."

Sources: Brown, George E. Jr., "Invest Social Security Surplus," *The Journal of Commerce*, Tuesday, November 24, 1987. "Science, Technology and Economics in the 1980's," Extension of Remarks by Hon. George E. Brown, Jr., *Congressional Record,* Monday, July 27, 1987.

Isabel Sawhill: Investing the Social Security Surplus

**Isabel Sawhill** of The Urban Institute notes that removing Social Security from the budget for Gramm-Rudman purposes would require an *additional* $99 billion in budgetary savings by 1993, and points out the futility of this approach given the deficit-reduction experience of the last several years. She argues that "if a higher target elicits greater political effort, or a willingness on the part of the public to sacrifice more, then removing Social Security from the calculations might make sense. But if all it accomplishes is a much bigger shortfall between intentions and results, it could prove politically and psychologically debilitating --

undermining confidence in the budget process, in the Social Security system, and in government itself."

She states that we should also not assume that private investment is always more productive than public investment. "Suppose that the best way to raise standards of living for our children is to insure that the next generation is healthier, better educated, and grows up in a drug-free environment. In this case, the Social Security surplus should be used to expand programs designed to achieve these objectives. Education, training, preventing drug abuse, child health care and nutrition would be obvious candidates for expansion. Currently, about 20 percent of total federal spending goes for these and other kinds of public investment, such as roads, bridges, and basic research. With the help of the Social Security surplus, this proportion could be expanded...**The only debate should be about the best way to raise future income. It is the next generation's standard of living and not some ficticious reserve that is the real guarantor of Social Security solvency**...Private investment in the form of new factories and equipment won't be all that useful if the workforce is poorly educated and trained, if transportation and communication are inefficient, or if the nation has lost its technological edge by failing to invest in basic research."

Source: Sawhill, Isabel. "The Social Security Surplus and Economic Growth," unpublished article dated September 3, 1988.

### D. Other Recent Investment Proposals

#### Michael Dukakis - Education Investment

Massachusetts Governor Michael Dukakis proposed the STARS (Student Tuition and Repayment System) program during the last Presidential campaign. STARS was intended to complement existing higher education programs by providing "all students with an option of repaying their college, vocational, or graduate school loans through a payroll withholding schedule proportionate to future earnings. [It was] to be a simple, self-supporting plan that would involve no increased costs to the federal government. Mr. Dukakis's proposal asserted that:

"by regarding a new source of affordable loans to all students -- regardless of income, the STARS program will serve four fundamental purposes:

"First, by providing a supplement for those whose Pell and Perkins grants aren't sufficient, *it will ensure that all students are able to go to college.*

"Second, it will help those working class students who have been squeezed out of eligibility for Guaranteed Student Loans, or whose GSLs are not sufficient to permit them to attend the college or graduate school of their choice.

"Third, *it will increase the available pool of education grants for lower income students* by: 1) reducing the default rate, and 2) lowering the number of students who take out subsidized GSL's.

"And fourth, by preventing students from being saddled with excessive debts, *the STARS program will encourage students to enter lower-paying public service jobs.*

The STARS program "would allow students to borrow directly from banks or their financial institutions. These loans would be guaranteed by the Federal government and paid back through withholdings of the students future earnings over their lifetime. Provisions will be created to allow those who wish the ability to "buy-out" of the plan at a cost that will protect the solvency of the system. *The government would not provide any subsidies or capital* - it would act solely as a clearinghouse for the repayments."

According to campaign literature, the STARS program differed from Reischauer's proposal in that it would "have absolutely nothing whatsoever to do with the Social Security Trust Fund. And where Reischauer's plan envisions dismantling decades of higher education assistance programs and replacing them with a federal debt, our plan builds on the foundation that Congress and states and private institutions have built. And it builds on it in a no cost way."

Source: Dukakis for President campaign materials.

Pat Choate - National Public Works Financing Bank

TRW economist Pat Choate has proposed the creation of a National Public Works Financing Bank, which would loan to projects that have a guaranteed revenue flow from user fees. By using state and federal funds for capitalization, instead of direct loans, the bank can provide leverage of $7-10 for every federal dollar. Local control of projects could be assured and general revenue could be freed up for projects that are not inherently revenue-generating.

Source: Choate, Pat and J.K. Linger, *The High-Flex Society: Shaping America's Economic Future*, (New York: Alfred A. Knopf, 1986).

Jesse Jackson - Infrastructure Investment

Jesse Jackson's National Investment Program would use federal loan guarantees to channel about 10% of the nation's public pension funds over a 10-year period into local infrastructure projects whose revenue would finance reinvestment in public works. Such projects would include low-income housing, traditional public infrastructure, and small business and community development projects.

At present, these projects are too small to attract the interest of pension fund managers, but if bundled, bonds could be issued with a Federal guarantee similar to those issued by FNMA and GNMA. The nation's pension funds - public and private - total about $2 trillion, with public pension funds totalling around $600 billion. Under the Jackson proposal, then, over the ten-year period, the federal government would be extending $60 billion in loan guarantees. The federally guaranteed securities would meet pension fund criteria for purchase, would be low risk, liquid and marketable, and would have a market-determined return.

Local/state governments would establish tripartite Public Benefit Corporations, which would evaluate and approve individual investment projects. Approved projects would then be submitted to a federally administered guarantee corporation, which would pool the projects and guarantee the security.

Mr. Jackson also proposed the creation of an American Investment Bank, "a domestic version of the World Bank to leverage pension fund capital to finance long term investments in American housing, transportation, infrastructure, R&D. The capital comes from state and local government workers; the investment opportunities and needs come from states and localities; the management represents a cooperation between public and private know-how." Each state would pledge an amount of capital to the Bank, "with only a fraction subscribed up front." The Bank would issue securities, backed by the states' subscriptions and credit, and market them to pension funds. Jackson believes this process "would leverage pension fund capital at a low enough cost to allow the Bank to re-lend the funds at a low interest rate for development projects." There would also be a tripartite board which would govern the Bank and set investment priorities. A professional staff would assess project proposals and help localities and states develop competitive investment opportunities.

Source: Jackson for President campaign material.

### David Rosen and David Schwartz - Housing Investment

David Rosen, a public finance consultant based in Oakland and David C. Schwartz, professor of urban studies at Rutgers State University and a member of the New Jersey state legislature, call for the creation of a "national housing trust that is self-financing, annually renewable and permanently dedicated to meeting our housing needs." They state that such a trust would provide the "large-scale capital resources needed to build, rehabilitate and preserve affordable housing for low- and moderate-income Americans."

The national housing trust would be capitalized by:

- a 0.2 percent property-transfer tax (exempting first-time home buyers) raising $1.7 billion annually,
- shifting 10 percent of home-interest deductions from the wealthy to the housing trust raising $3.5 billion,
- a new 1 percent tax on mortgage-backed securities raising $1.8 billion a year,
- allocating 5 percent of the Federal Reserve Board's annual earnings generating $1 billion a year,
- tapping the 6-10 percent interest earnings from tenant-security deposits raising between $800 million and $1.4 billion annually, and
- tapping the 6-10 percent interest earnings on mortgage-escrow accounts raising $500 million to $1 billion after reimbursing lenders for the administrative expenses.

Rosen and Schwartz note that the bipartisan federal housing policy that seems to have emerged in recent months includes four key elements: "1) a federal housing block grant, building on innovations amoung states and cities since 1981, that would link federal spending to state and local housing efforts; 2) a community-based housing-supply program that would encourage non-profit, community groups to develop, own and manage low-cost rental housing; 3) an employer-assisted housing program that would provide incentives for employers to offer home-ownership assistance as a personnel benefit to wage workers and mid-level employees; and 4) a homeless prevention program that would address the root cause of homelessness in an effective, comprehensive, and humane manner."

Source: Rosen, David and David C. Schwartz. "National housing trust fund would save the American dream," *Los Angeles Herald Examiner*, May 20, 1988.

### Miscellaneous Trust Fund Proposals

An October 1988 *National Journal* article by Lawrence J. Haas notes that "as budget deficits continue to constrain spending, lawmakers and lobbyists are drafting proposals to raise and set aside revenues in trust funds for specific purposes." The article mentions the defeat of Rep. Claude Pepper's long-term health care bill which was to be financed by raising the medicare payroll tax and putting the receipts into the medicare trust fund to be used for that program only, and draws attention to several other health care bills with similar financing mechanisms.

Haas' article included several other initiatives as well:

**Catastrophic illness** - In June 1988, Congress approved a bill that created a new trust fund financed by a new tax and higher premiums to provide care for catastrophic illnesses.

**Vaccine-related injuries** - In early 1988, Congress created a fund to "pay victims of vaccine-related injuries" financed by a tax on childhood vaccine sales.

**Open space and recreational opportunities** - Rep. Morris K. Udall and Sen. John Chafee have introduced legislation to create a $1 billion-a-year trust fund to "preserve open space and recreational opportunities."

**National park and forest systems** - Haas notes that George Bush's campaign literature reveals that he supports "the creation of a self-perpetuating trust fund to protect and build national park and forest systems."

**Nuclear waste cleanup** - Sen. Brock Adams and Rep. Don Bonker have proposed a trust fund "to help clean up nuclear waste sites, including their state's Hanford Nuclear Reservation. Funds would come from a $1 billion appropriation for each of three years and from fees for nuclear power users."

**Highways and other public works** - The Private Sector Advisory Panel on Infrastructure Financing called for a trust fund "to distribute $5 billion a year for five years to finance state spending for highways, water projects, and the like. the trust fund would pay 80 percent of the cost, and states would be required to contribute the rest."

**Children's programs** - Jule M. Sugarman, Washington state's Social and Health Services secretary, has called for the creation of a "children's trust fund" to be financed by an increase in the social security payroll tax of almost $20 billion annually.

Source: Haas, Lawrence J. "Paying As You Go," *National Journal*, October 22, 1988.

Mr. **Moody**. Thank you very much. Very interesting and valuable testimony.

You do propose marketing these and propose giving them a high national profile. How about tax incentives, per se? I know you have not fleshed all of those details out. Do you have any thoughts on that?

Mr. **Levine**. I happen to believe, Mr. Chairman, that we need four prongs to this program. The principal one is the one I outlined in my testimony, being a very focused and targeted and highly visible national campaign which ultimately will involve the public in terms of investment bonds.

I also think that we can't afford to ignore the other three points that have been discussed, cutting the deficit and doing it in a much more urgent fashion than unfortunately this proposed budget that I have been hearing about accomplishes.

Second, savings incentives and, third, debt disincentives. I understand the appropriate reluctance of making changes from what we have done in 1986, but I do believe that there ought to be savings incentives. I think that the Tax Code can be used more aggressively in that fashion.

I am particularly interested in some form of proposal where we have more tax incentives in IRA's. We shouldn't allow a shift from one account to another to escape paying taxes. IRA's should be structured to increase the total savings rate. I would defer to the committee on this because I think that the members and staff of this committee have as much expertise in this area as anybody.

But I would think this is something the committee could very productively look at.

Mr. **Moody**. We had some very strong testimony a little while ago from economists who basically agreed with what you said. IRA's, at least in the short run, lost money. Under budget pressures, they had to go to make the 1986 package neutral.

So they went. There are some academic studies that have since come out that seem to indicate that they did stimulate savings, although we could detect a lot of shifting which does not itself create savings.

I think it should be revived. I am glad to hear you want to include it as one of the possible ways of achieving your goals.

One of the casualties of being under these kinds of deficit pressures is it is hard for us to structure our tax system to look for longer term solutions because most of them involve some sort of near-term revenue loss, whether it is IRA's or whatever.

The previous witness, Billy Tauzin, proposes stimulating savings. There is some short-term revenue loss.

Mr. **Levine**. I certainly wouldn't want to trade places with you in terms of having to finally come to grips with these extraordinarily difficult choices.

Until we are willing to face up to the need for revenues, which apparently we are not willing to face up to even in the fiscal year 1990 budget, it means we are going to have to avoid other extraordinarily urgent national goals.

What troubles me so much and what exasperated me so much when I heard about the budget compromise that is being discussed is that we are simply putting off the day of reckoning.

As we put off the day of reckoning, the stakes become more urgent and the gamble becomes much more serious in terms of whether we are risking the economic underpinnings of this country and ultimately the globe.

Unless we are prepared to take some of the medicine that needs to be a part of putting us back on our feet for the long term and doing the kinds of things that need to be done in order to ensure that we can save, ultimately we will not face up to the tough choices we need to face up to.

Until that framework is established, I understand how difficult it is for this committee, but I think it is time for us to get up on our hind legs and make clear to our colleagues and to our country that the time is now, and if we are not prepared to act in the direction that this committee is at least by implication suggesting by holding these hearings, we are putting off decisions of great magnitude for us all.

Mr. MOODY. The structure of the problem that you are describing—postponed difficulty but important choices—is similar to the S&L problems.

We decided on a slide-by approach for the last 3 years. The S&L problem was identified up to 3 years ago.

Two years ago, it was pretty clear. We decided we could slide by. Now we know the cost of sliding by.

Mr. LEVINE. It is a sad but solid analogy.

Mr. MOODY. Thank you for your leadership.

Mr. LEVINE. Thank you, Mr. Chairman.

Mr. MOODY. We have another panel, I believe. We have John Regan, founder and director of the Regan Group Insurance Marketing; and we have Howard Weizmann, Association of Private Pension and Welfare Plans.

Would you be good enough to share the panel together?

You may proceed.

## STATEMENT OF JOHN D. REGAN, FOUNDER AND DIRECTOR, THE INSURANCE COALITION OF AMERICA; PRESIDENT AND CHIEF EXECUTIVE OFFICER, GENERAL SERVICES LIFE INSURANCE CO., AND CHAIRMAN, REGAN GROUP INSURANCE MARKETING

Mr. REGAN. Mr. Chairman, and members of the committee, my name is John D. Regan. I am founder and director of the Insurance Coalition of America, Inc., which represents the interests of those who purchase and sell life, health, and annuity insurance. In addition, I am president and chief executive officer of General Services Life Insurance Co. and chairman of the Regan Group Insurance Marketing.

Funds accumulated under insurance and annuity products are particularly well suited to investment in long-term corporate capital spending and commercial construction; and consequently, the insurance industry is a most appropriate source for funding expenditures that facilitate economic growth.

Unlike time deposits and securities, life insurance is traditionally sold rather than purchased because the advantages of this long-term, intangible investment are not always immediately obvious to consumers. If attractive insurance options were not available, the money now going into life insurance premiums more than likely would be spent on consumer goods—many of them foreign made—and on vacations and other commodities, sending more of our resources to other countries, instead of reinvesting them in our economy.

Therefore, it is my contention that the life insurance industry not only contributes to the Nation's capital base by generating capital, but that this is, to a large degree, truly additional capital. By selling individuals and businesses programs to provide for themselves, the insurance industry facilitates the public policy goal of individual self-sufficiency and, therefore, contributes to the important objective of reducing future demands on social programs.

Insurance companies accumulate savings from individuals and businesses that choose to purchase insurance products rather than to directly buy long-term government or corporate bonds, for example, because they want immediate book-value liquidity rights should an emergency arise. The insurance companies then guarantee those liquidity rights to each individual policyholder and simultaneously invest many of these dollars directly into long-term investments, absorbing the disintermediation risk at the company level.

But despite my industry's contribution to savings today's U.S. savings rate is cause for real concern. By 1987, the savings rate in U.S. households had shriveled to just 3.3 percent, down from 7.3 percent at the beginning of the decade, and 8.1 percent in 1970. U.S. savings reached 19.1 percent in 1945, coincident with this country's postwar boom.

Our savings rate is about one-fifth of the average rate of the leading industrial nations. For example, in 1987, the average Japanese household saved 16.8 percent of its income; Germans 12.4; French, 12.1; Italians, 21.9; Canadians, 9.7; British, 5.4; Belgians, 12.2; and Singapore and Korea are higher still. Our savings rate is clearly the lowest of all of these.

Certainly the differential in Japanese and American savings rates tells only part of the story of Japan's economic development and trade surplus. But their investment in life insurance is an important part of the story.

In Japan, lump-sum endowment insurance policies and variable insurance programs are investment tools that the Japanese view as competitive with other financial products for savings and investment. The Japanese also use life insurance as a vehicle to save for buying homes and other major consumer durables.

Japan imposes no taxes on policy holders and only ordinary business taxes on insurance companies. Japan made life insurance an even more attractive investment when the Government last year began taxing the interest on previously tax-free savings deposits.

It is not surprising that Japan leads the world in life insurance protection.

Nippon Life was the third largest insurance company in the world in 1986, with $26 billion less in assets than Prudential; and in 3 short years, Nippon has surpassed both Prudential and Metropolitan and has become the largest life insurance company in the world.

Looking at the ratio of life insurance in force to national income shows the significance of life insurance in the national economy.

Japan leads with insurance protection equal to more than three times—339 percent—its national income, followed by South Africa—252 percent, Canada—188 percent, Ireland—183 percent, and the United States—179 percent. However, a number of factors in the United States currently restrict our industry's role in obtaining capital for investment in America's economy.

For example, to enjoy tax status as life insurance, a contract must comply with various tests—first TEFRA, then DEFRA, and TAMRA—resulting in a continually increasing part of any premium being used to pay for pure "risk" or pure life insurance protection.

In addition, there are taxes on loans and withdrawals and nondeductibility of policy loan interest, at the end-user level, all imposed even though there is no evidence the money was being withdrawn by individual consumers at any significant rate.

Finally, there are nondeductible reserves and continual talk of taxing the inside buildup, all of which do little to add to consumer confidence.

The budget deficit impacts national savings available for economic growth. In 1987 U.S. life insurance companies invested 34.1 percent of their assets in government bonds, up from 11.2 percent in 1977.

As you may contemplate future legislative initiatives that involve the insurance industry, we ask that you consider our contribution to individual self-sufficiency and, therefore, the future cost of government programs, national savings, and to interest payments on the national debt.

Instead of continuing to limit the attractiveness and therefore the effectiveness of current solid performing long-term savings and capital accumulation vehicles, I would like to propose:

First, that life insurance companies' reserves to fund future benefits be deductible to eliminate the difference between tax reserves and real reserves;

Second, that Congress consider new legislation to encourage long-term savings, that is, the decade tax.

When any insurance company, bank, or private individual makes a commitment of funds for 10 years or longer, the investor's interest and the national interest coincide. Therefore, I am proposing that Congress consider legislation which would provide additional or new tax incentives for long-term investment of 10 years or more.

I thank you for the opportunity to present these views today, and I welcome your questions.

[The statement of John D. Regan follows:]

## STATEMENT OF JOHN D. REGAN

## INSURANCE COALITION OF AMERICA, INC.

Mr. Chairman, and members of the Committee:

My name is John D. Regan. I am founder and director of the Insurance Coalition of America, Inc., which represents the interests of those who purchase and sell life, health, and annuity insurance. The coalition's 20,000 members are primarily individuals who work in or own small and medium-sized businesses. In addition, I am president and chief executive officer of General Services Life Insurance Company and chairman of The Regan Group Insurance Marketing.

Mr. Chairman, I appreciate your allowing me to testify today as a representative of end users of life insurance and annuity products to discuss the important contribution that the life insurance and annuity industry makes to U.S. savings. Our industry historically has played an important role in the accumulation of capital for our nation's economy. The American Council of Life Insurance (ACLI) calculates that life insurance and private pensions make up about a third of our net personal savings.[1] (Investments in securities and in time and savings deposits represent another one-third each.)

The life insurance and annuity industry thrives on financing the growth of our economy. From the perspective of investment in America's future, life insurance savings are its backbone: Funds accumulated under our products are particularly well-suited to investment in long-term corporate capital spending and commercial construction, and consequently, the insurance industry is a most appropriate source for funding expenditures that facilitate economic growth. Figures from the ACLI show that at the end of 1987, 65 percent of all financial assets of life insurance companies and private pension funds were invested in corporate equities, corporate bonds, and commercial mortgages.[2]

But these percentages tell only part of the story. Our nation needs, as these hearings attest, an improved savings rate that broadens the base of capital available for business investment.

By 1987, the savings rate in U.S. households had shriveled to just 3.3 percent; that is down from 7.3 percent at the beginning of the decade,[3] and 8.1 percent in 1970.[4] U.S. savings reached 19.1 percent in 1945,[5] coincident with this country's post-war boom.

Today's U.S. savings rate is cause for real concern! Our savings rate is about one-fifth of the average rate of the leading industrial nations. For example, in 1987, the average Japanese household saved 16.8 percent of its income; Germans saved 12.4 percent; the French, 12.1 percent; Italians, 21.9 percent; Canadians, 9.7 percent; the British, 5.4 percent; and Belgians, 12.2 percent.[6] Our savings rate is clearly the lowest of all of them!

The following table[7] shows savings rates over a 27 year period:

Net household savings as a percentage of disposable household income[8]

| | 1960 | 1971 | 1980 | 1987 |
|---|---|---|---|---|
| U.S. | 7.2 | 8.8 | 7.3 | 3.3 |
| Japan | 17.4 | 17.8 | 17.9 | 16.8 |
| Germany | 8.6 | 13.5 | 12.7 | 12.4 |
| France | 11.5 | 18.2 | 17.6 | 12.1 |
| United Kingdom | 4.5 | 7.6 | 13.8 | 5.4 |
| Italy | 16.5 | 30.6 | 28.0 | 21.9 |
| Canada | 3.9 | 6.9 | 13.6 | 9.7 |
| Belgium | 10.5 | 16.8 | 16.2 | 12.2 |
| Switzerland | 8.5 | 11.5 | 3.3 | 7.9 |
| Australia | 9.3 | 10.7 | 10.5 | 8.7 |

By holding these hearings, Mr. Chairman, you are wisely acknowledging that our shrinking savings rate is a serious problem for our country that could impact our children and grandchildren into the next century. Savings finances the investment in research and development, plants, and equipment that allow our economy to grow and compete in the international marketplace. Because we are a high-wage nation, we must become increasingly efficient to compete, and this requires continual investment in R&D to develop new technologies and thereby increase our productivity. If the U.S. savings rate increased, capital would be less expensive, stimulating more investment and promoting stronger economic growth.

It is generally recognized that Japan's high savings rate is a cornerstone of that country's economic development. Its savings provide a large pool of funds for business investment and growth and also keep interest rates low. With lower interest costs, the Japanese are able to price their goods more competitively in the international market, winning a greater market share.

Certainly the differential in Japanese and American savings rates tell only part of the trade story, but as the Japanese trade surplus with the U.S. continues to widen, we need to look at all elements of the problem, including ways to enhance U.S. savings.

International comparisons

Because life insurance is an important reservoir of funds for business investment which affects our international competitiveness, it is appropriate to look at how a major competitor treats this savings resource.

In Japan, insurance policies are increasingly seen as attractive savings vehicles which also protect policy holders against financial losses due to sickness and emergencies and provide for post-retirement living expenses. The Japanese also use life insurance as a vehicle to save for buying homes and other major consumer durables.[9] Life insurance is an attractive savings/investment option because Japan imposes no taxes on policy holders and only ordinary business taxes on insurance companies.[10] Japan made life insurance an even more attractive investment when the government last year began taxing the interest on previously tax-free savings deposits. Lump-sum endowment insurance policies and variable insurance programs are investment tools that the Japanese view as competitive with other financial products.

It is not surprising that Japan leads the world in life insurance protection. In 1987, the Japanese collectively held about a quadrillion yen in life insurance coverage.[11]

It is difficult to compare life insurance in force in different countries because of differences in personal income levels, living and health standards, and other factors. But one measure that somewhat levels the field is the ratio of life insurance in force to national income; this shows the significance of life insurance in the national economy.

Again, Japan leads with insurance protection equal to more than three times (339%) its national income, followed by South Africa (252%), Canada (188%), Ireland (183%), and the U.S.(179%).[12]

Nippon Life is the largest life insurance company in the world and is a significant source of funds for Japanese business investment. But of even greater importance, Nippon Life was the third largest insurance company in the world in 1986, with $26 billion less in assets than Prudential and $3 billion less than Metropolitan Life; in three short years, Nippon has surpassed both Prudential and Metropolitan in assets, and has moved to the number one spot.

As I stated earlier, life insurance and private pensions make up about one-third of U.S. net personal savings. If we were to undercut this important savings tool by implementing policies that make saving through life insurance protection less attractive, we would be further assuring our place at the table of second-rate debtor nations.

### Capital accumulation

Life insurance gives people the option of protecting themselves now and their families in the future while contributing to a reservoir of funds that helps the economy grow. And, unlike time deposits and securities, life insurance is traditionally sold rather than purchased because the advantages of this long-term, intangible investment are not always immediately obvious to consumers. If attractive insurance options were not available, the money now going into life insurance premiums more than likely would be spent on consumer goods, (many of them foreign-made) and on vacations and other commodities, sending more of our resources to other countries instead of being reinvested in our economy.

Therefore, it is my contention that the life insurance industry not only contributes to the nation's capital base by generating capital, but that this is, to a large degree, truly additional capital.

In 1987, nearly three-fourths of new life insurance protection purchased in the U.S. was bought by individuals for family protection and long-term savings. Insurance companies accumulate savings from individuals and businesses that choose to purchase life insurance products rather than directly buy long-term government or corporate bonds, for example, because they want immediate book-value liquidity rights should an emergency arise. The insurance companies then guarantee these liquidity rights and simultaneously invest many of these dollars directly into long-term investments, absorbing the disintermediation risk at the company level.

However, a number of factors currently restrict our industry's role in obtaining capital for investment in America's economy. For example, to enjoy tax status as life insurance, a contract must comply with various tests -- first TEFRA, then DEFRA, now TAMRA[13] -- resulting in a continually increasing part of any premium being used to pay for pure "risk" or pure life insurance protection in all age groups. In addition, there are taxes on loans and withdrawals and non-deductibility of policy loan interest, at the end-user level. Yet, there is no evidence the money was being withdrawn by individual consumers at any significant rate.

Another restriction involves the non-deductibility of life insurance reserves at the company level for income tax purposes to provide non-guaranteed future benefits. All of these factors affect the resources available for our companies to invest in economic development.

But still, life insurance companies attempt to continue to fulfill their traditional role in accumulating capital for the nation, providing protection for individual citizens while at the same time they must meet interest rate competition from tax exempt municipals, unregulated bank interest rates, junk bond high interest credits, etc., after paying acquisition costs and the costs of providing pure protection in the event of the insured's death.

## Self-sufficiency

It is generally acknowledged that our national budget deficit is a significant drain on savings resources and contributes directly to our international trade imbalances. In that vein, it is important to protect against excessive demands on federal funds in the future. And again, life insurance comes into play.

By purchasing life insurance, individuals are providing for their own financial security and that of their families in their retirement and after death. The insurance industry facilitates the public policy goal of individual self-sufficiency and fulfills the important objective of reducing future demands on social programs.

## Financing the national debt

The budget deficit also impacts our industry, and national savings, in other ways. As the government borrows more, it crowds out private borrowing. In 1977, U.S. life insurance companies invested 11.2 percent of their assets in government bonds. By 1987, the amount spent on government bonds had tripled to 34.1 percent.[14]

Certainly we need public policies to encourage a greater savings rate in this country. But equal attention needs to be paid to reducing the budget deficit so the savings that are available can be reinvested in economic growth rather than government spending. Adopting further laws which would cripple a key financier of the interest on the national debt does not seem at all wise.

## Common interests and a long-term investment proposal

The life insurance industry and the American economy share a common interest: Our industry wants to make long-term investments to provide for future benefits to our policy holders, and the U.S. economy needs our resources to finance its growth for the future. These issues go the heart of these hearings, Mr. Chairman, since the implications will extend over decades.

As you may contemplate future legislative initiatives that involve the insurance industry, we ask that you consider the impact on our contribution to national savings and to interest payments on the national debt. Our ability to collect savings through life insurance policies would be inhibited by legislation to tax inside build-up, limit the deduction presently allowed for additions to life insurance reserves, and further limit the contribution or benefits allowed under qualified pension plans.[15]

If the cost of purchasing life insurance were to be raised through further expansion of the TEFRA, DEFRA, and TAMRA tests, our pool of funds would shrink and so would the capital base available to finance America's economic growth and international competitiveness.

I appreciate your giving me the opportunity today to provide details on my industry's contribution to our national savings. Now I would like to make a proposal for new legislation which I believe would specifically encourage long-term savings. When any insurance company, bank, or a private individual makes a commitment of funds for 10 years or longer, the investor's interests and the national interest coincide. Therefore, I am proposing that Congress consider legislation which would provide additional or new tax incentives for long-term investments of 10 years or more.

As our national debt has swollen over this decade, it is increasingly clear that our children and even our grandchildren will have to pay for our spending. The legislation that I am proposing would have the opposite effect by allowing us to generate new savings today to finance tomorrow's economic growth. Such legislation would specifically encourage the kind of capital formation that could help to provide a stronger economy for our children.

I thank you for the opportunity to present these views today, and I welcome your questions.

ENDNOTES

1. In 1987, life insurance and private pensions constituted $121.4 billion of personal savings. (American Council of Life Insurance statement on "Savings, Economic Growth and Federal Deficit Reduction" to the National Economic Commission. January 27, 1989.)

2. Ibid.

3. Organization for Economic Cooperation and Development (OECD) figures on net household savings as a percentage of disposable household income.

4. Statistical Abstracts of the United States. 1971.

5. Statistical Abstracts of the United States. 1960, 1971, 1988.

6. OECD.

7. Based upon OECD figures on net household savings as a percentage of disposable household income.

8. Ibid.

9. Cullison, A.E. "Insurance Opens Doors in Japan," Journal of Commerce, April, 5, 1989.

10. "Updating of the study on supervision of private insurance in member countries, summary tables of insurance supervision," OECD, June, 1987.

11. 1988 Life Insurance Fact Book. ACLI. p. 107.

12. 1988 Life Insurance Fact Book. ACLI. Percentages are based upon 1986 data, the most current available.

13. The definition of life insurance first introduced in the Tax Equity and Fiscal Responsibility Act of 1982 (TEFRA) and later expanded in the Deficit Reduction Act of 1984 (DEFRA) and in 1988 in the Technical and Miscellaneous Revenue Act (TAMRA).

14. 1988 Life Insurance Fact Book. ACLI.

15. ACLI. January 27, 1989.

GSL

GENERAL SERVICES
LIFE INSURANCE COMPANY

John D. Regan
President & Chief Executive Officer

May 30, 1989

The Honorable Andrew Jacobs, Jr.
U.S House of Representatives
Washington, D.C. 20515

Dear Congressman Jacobs:

I appreciate your giving me the opportunity to testify before The Ways and Means Committee during your recent hearings on the national savings rate and its implications for the long-term health of our economy and future standard of living. I was, of course, testifying as a representative of end users, producers and manufacturers of life insurance and annuity products. As you know, the life insurance industry historically has played an important role in the accumulation of capital for our nation's economy, with life insurance and private pensions making up a third of the country's net personal savings.

During my oral statement, I made a proposal which I would like to explain in more detail here. I believe that this proposal would have a dramatic effect on improving our national savings rate and particularly in enhacing long-term savings, which are, of course, the life-blood of a healthy economy.

Let me state at the outset that this is not a request for special tax treatment for life insurance products. My proposal is this: that new legislation be considered to encourage long-term savings by enacting a "Decade Tax" in which the earnings on any investment for 10 years or longer would receive special tax treatment.

When any individual or business makes a commitment of funds for 10 years or longer, the investor's interest and the national interest coincide. I believe our nation would benefit if long-term savings and capital accumulation vehicles were made more attractive.

Strong support could be generated for this proposal in a number of other industries which invest and borrow long-term capital. It would encourage capital formation and provide the vital resources American industry needs for research and development, plant construction, and investment in productive equipment. And the Decade Tax certainly would be popular among individual savers who would have a renewed incentive to save long-term by receiving a lower tax rate on the earnings from such investments.

JUN 5 1989

I am keenly aware of the need to balance such a proposal with a means to finance it. In that regard, let me propose that the tax on investments held less than a year be increased. Certainly the Joint Committee on Taxation would need to do the precise revenue estimation, but common sense indicates to me that the revenue effects would be neutral while the benefit to our economy and its future growth would be significant.

Certainly life insurance companies likely will be holding many of these long-term investments so there would be some indirect advantage to my industry. But there would be major benefits to many other industries as well, with the U.S. economy as the major beneficiary.

I appreciate your consideration of this proposal and would be happy to provide any additional materials or information that you may require.

Very truly yours,

John D. Regan
Founder and Director
Insurance Coalition of America, Inc.

Mr. Moody. Thank you very much. We will make this available to all the other Members.

As you know, today is a day off here in Congress, so we don't have full membership.

Mr. Weizmann.

## STATEMENT OF HOWARD C. WEIZMANN, EXECUTIVE DIRECTOR, ASSOCIATION OF PRIVATE PENSION AND WELFARE PLANS

Mr. Weizmann. Yes. Thank you, Mr. Chairman.

First, what would a Ways and Means Committee hearing be without the mention of section 89 this year? I would like to commend the chairman, who I know has left, but some of his staff, as well, and certainly other members of the committee who have decided to cosponsor the chairman's initiative on section 89 for working with us.

We have worked with much of his staff through the course of the last year and a half, and I am sure that we will bring this to a successful conclusion. Once again, I do commend everybody who has been involved in this process, and hopefully, it will continue.

We are usually here talking about three-legged stools, and today, I will talk about a three-legged pig. Let me say that I am the executive director of APPWP. We represent over 400 consultants in the benefits area, employers who sponsor benefits and insurance members.

We are concerned particularly about savings, and I think if I say nothing else, I have to tell the story of the three-legged pig which some of you may have heard.

There was a farmer who had invited a friend over to his house and noted that there was a three-legged pig on the property; asked the farmer about what is special about this pig. The farmer said, "This pig is a very fancy pig. Six months ago he leaped in the farm pond and saved my son from drowning. Three months ago, that same pig climbed up the stairs and rescued my wife from a burning house."

The friend noted, he said, "Well, why does this pig only have three legs?"

And the farmer answered, he said, "With a pig like that, you don't want to eat him all at once."

That, quite frankly, is what is happening to the private pension system in today's world. Let me say something about the role of private pensions in savings.

First, corporation pensions substitute for private savings in a major way. Studies have demonstrated that they would have to save 3 to 7 percent to make up for what employers put aside for them.

Federal and military pensions, which are not funded and do not contribute to savings, those rates would be higher since the promised benefits are higher.

Corporate pension funds provide benefit security for millions of Americans, that is active today, thereby reducing the need for direct Federal expenditures to support the elderly.

At the same time, on a national level, retirement funds fuel the American economy, pension contributions accounted for 51.3 percent of all new savings in 1986 and accounted for 34.8 percent of investment capital supplied by nonbanking institutions; and yet the system is in trouble.

We find that over the years we have watched—particularly over the last 7 years we have watched the system gradually be eroded by legislation dictated as you have heard already in other areas by short-term revenue needs.

Given the long lead time necessary to assess the damage to the system, it is often difficult to present statistics which, in fact, demonstrate that the system is slowly stagnating and eventually will die.

But we do know what the evidence is. Fully 15 percent of the assets raised in the tax reform process came from tax increases levied on the employee benefits area.

New limitations on section 401 plans, which are savings plans along the lines discussed earlier today, have further curtailed the amount that can be put aside by average workers, as well as high paid workers, in these plans.

During the past 7 years, these amounts have been whittled down. In one particular area, code section 415, which acts as a limit, and congressmen often mistake this as a limit on the amount of pensions simply that can be paid to highly compensated employees, but it serves as a funding limit.

Over the last 7 years, we have seen this funding limit gradually whittled away, starting in 1982 and commencing in or continuing on into CPO proposals that annually provide for discussion.

Full funding limitations that were imposed in 1987 took pensions off the projected liability standard, if you will, in terms of funding and now require pensions to be limited in their funding to simply current liabilities. That is going to destroy the system.

Business is supporting many of the changes in the Pension Protection Act, cosponsored or singularly helped along by Congressman Pickle, and we still feel very strongly about those. However, the new funding rules introduced new volatility in the system.

It has been introduced by the accounting professionals, requiring employers to, if you will, judge on an annual basis what their liability is and what their assets are to meet that liability that must go on their books.

Unfortunately, this volatility in a system is causing and will cause a shift in the type of investments that are being made by pensions away from equities to long—from long-term investments to shorter term and fixed investments.

My association, Mr. Chairman, calls for the establishment of a national policy commission. At this point, we have had them before; but this one, I think is in dire, is a dire requirement.

We would like to step back—we would like everyone involved in this process to step back and ask ourselves, what is national retirement policy? What is our national savings policy, and how do our plans get focused to achieve both?

That is all I have to say. I see my time is up.

[The statement of Howard C. Weizmann follows:]

APPWP
Association of Private Pension and Welfare Plans

STATEMENT OF THE ASSOCIATION OF PRIVATE PENSIONS AND WELFARE PLANS (APPWP) ON "NATIONAL SAVINGS AND ITS IMPLICATIONS FOR THE LONG-TERM HEALTH OF OUR ECONOMY AND FUTURE STANDARD OF LIVING" BEFORE THE WAYS AND MEANS COMMITTEE OF THE U.S. HOUSE OF REPRESENTATIVES

APRIL 20, 1989

As the Executive Director of the APPWP, a nonprofit organization founded in 1967 to protect and foster the growth of this country's private employer-sponsored employee benefit system, I am pleased to speak on an issue that is of such great concern to our over 400 employer, benefit consultant, banking and insurance members. We commend the Committee for holding these hearings on an issue of such great importance to all Americans.

These hearings by themselves bear witness to concern over the steep decline in the U.S. savings rates since the 1970s when U.S. personal savings, as a percent of disposable personal income, averaged 8.3 percent from 1970 to 1978, to the period since 1985 when they have averaged below 4.5 percent. As a percent of gross national product (GNP), personal savings in the United States declined from 4.8 percent in 1976 to around 3 percent in 1987, the lowest of all industrialized countries. As a percentage of GNP, the U.S. savings rate compares poorly to that of nearly 17 percent for Japan and 12 to 21 percent for Germany, France and Italy.

This forty-year low has many economists alarmed, and has many and varied explanations. Some blame demographics -- baby boomers are now in their prime consumption years while some contend that Boomer's receive lower levels of compensation than their parents did. The 1981-82 recession and the federal budget deficit have also been cited as contributing to the decline in the savings rate.

Little recognized in the overall declining savings rate story is the positive impact that private pension and profit sharing funds have had on what savings have occurred during the 1980's. Private pension assets, which have also grown impressively over recent years, have an enormous, positive impact on the health and vitality of the U.S. economy. Today, 875,000 private sector employer-sponsored pension plans have assets totalling approximately $1.2 trillion. If we count public funds, this number reaches $2 trillion. These funds play an important role in both providing benefit security in the form of corporate savings on behalf of millions of employees and in providing for the capital needs of the U.S. economy.

That the low savings rate has serious implications for America's ability to compete with its trade partners is widely recognized. That policies which we have been pursuing and seem likely to continue to pursue are undermining the private voluntary retirement system--the one shining light in the U.S. savings record--is not widely appreciated and is our reason for testifying here today.

## Corporate Savings on Behalf of Employees

In 1986 contributions to private retirement and insurance funds represented the lion's share of savings in the United States. While more than half the U.S. labor force has little or no private individual savings, more than 70 percent of long-term, full-time employees participate in employer-sponsored retirement plans.

This is not mere happenstance. The U.S. tax code has implicitly endorsed the value of a private pension system throughout most of this century. Beginning in 1921, the tax code provided for the tax exemption of income earned by stock bonus and profit-sharing plans and thus began to provide tax incentives for the express purpose of encouraging employers to establish and maintain retirement plans for their employees. Between 1950 and 1986, the number of active participants in the private pension system increased more than fivefold, and the share of employees participating in employer plans more than doubled. Nearly two-thirds of employees working 2,000 hours or more per year participate in an employer-sponsored plan.

During the same period the rate of poverty among the elderly population also declined dramatically, from over 30 percent in the early 1960s to 14 percent in 1983, and the rate of poverty among the elderly has fallen below that of the nonelderly. This decline can be attributed to the successful interplay and growth of the three-legged stool of retirement income -- Social Security, private pensions and individual savings, bolstered of course by the positive impact of Medicare on the financial security of the elderly. Thus today a very large segment of the elderly population receives two checks each month: one from social security and one from a private pension. And because they were a generation of resolute savers during their working years--a habit not yet embraced by the current generation of baby boom-era workers -- current retirees are by and large enjoying a retirement that is secure and dignified. This provides comfort not only to them, but safeguards the financial well-being of their children as well.

How important are corporate sponsored savings on behalf of employees? David Wise, a widely published economist on these issues, in a draft paper submitted to the National Bureau of Economic Research, estimates that employees would have to save on average between 3 and 7 percent of their wages to make up for what employers put aside for them. Comparable rates for the Federal Civil Service pension plan would be about 35 percent. Military employees would have to earn twice as much as they do and save half of it to provide pension benefits equivalent to those provided by the military pension plan. Unfortunately for both the military and federal employees and the nation, however, both the federal and military pensions are unfunded promises and do not add to national savings.

Moreover, the scope of tax code incentives provided to private retirement plans have traditionally provided employers with the flexibility to shape innovative pension programs to suit the needs of changing and differing workforces. The private pension system has developed not as a one-size-fits-all system, but rather as one that could adapt and change with the times. For example, during the 1970s, wage inflation led to the growth of plans which base pensions on salaries earned at the end of one's career, (i.e. "final pay plans") that enable employee pensions to keep pace with the times. Cash or deferred plans permitted under Section 401(k) of the Code have provided an enormously popular savings incentive, enabling employees to accumulate substantial portable savings.

Regrettably, some policy makers have come to view private pensions primarily as tax loopholes, apparently overlooking or not comprehending the long-term benefit to the federal budget. Private pension checks eliminate or minimize costly reliance on federal income security and transfer programs by impoverished elderly, a financial benefit that cannot be measured. Furthermore, up to 75 percent of pension-related tax deferrals are repaid when benefits are taxed on retirement.

Private pensions offer a very broad, middle-class benefit. Figures for 1982 show that 76 percent of those nonagricultural workers with pension coverage earned less that $25,000; in 1982 this same group held 70 percent of all vested pension benefits. Yet many policy makers now regard private pensions as a rich vein of new revenue to feed the deficit because they mistakenly regard the system as one which benefits chiefly the highly-paid.

In sum, the value of the private benefits system to the Federal government is self evident. Without corporate savings on behalf of individuals there might be even less in the way of retirement savings than there is today. While the cost of the tax revenues forgone by the federal government amounts to $49 billion dollars, the "outlay equivalent" or the amount the federal government would have to spend to replace the system would be around $60 billion. By providing for the retirement security of millions of Americans, these public expenditures which, unlike federal and military pensions, would otherwise go towards providing financial support to the elderly are not required. Such public expenditures would further exacerbate the deficit and deepen the U.S. capital crisis brought on in part by the lack of individual savings.

## Private Retirement Funds as a Source of Capital

Thanks to the enlightened policies established in the early 1970's, the financial situation for most plans has also improved over the last decade. Between 1981-1987 most large plans became fully funded with respect to accrued benefits. The Department of Labor has estimated that in 1986 the assets of single-employer defined benefit plans were more than sufficient to pay current liabilities and to provide a substantial cushion to insure the payment of their projected liabilities. The number of insufficient plan terminations declined each year since 1983. However, the greatest financial strength has been in asset growth: In 1950 public and private pension funds held only 3 percent of the total financial assets in the economy, By 1970, they held 9 percent of all financial assets. During the 1980's, the value of private pension assets grew by 13.6% each year so that by 1987, the pension plan share of total financial assets in the economy had risen to 18 percent.

This dramatic growth coupled with stringent legal diversification requirements enacted in 1974 enabled plans to withstand comfortably the October, 1987 market crash. Pension fund losses during the month surrounding the crash were more than offset by earlier gains; pension assets showed net earnings of 6.6% for 1987. Further, pension funds are one of the major holders of corporate stock, holding 18 percent of all publicly traded equities in 1987.

While the U.S. economy greatly benefits from the benefit security provided by the private pension system to individuals, retirement funds of both defined contribution and defined benefit plans also help fuel industrial expansion, retooling, and job creation. Pension funds contribute greatly to America's ability to compete with our increasingly aggressive trade partners by transferring income from current consumption to building productive resources. These assets--funds that remain in trust after payment of withdrawals, plus earnings and new employer contributions--are a major investment vehicle in the U.S. economy and comprise the largest source of business investment capital. Pension funds accounted for 34.8% of the investment capital supplied by financial institutions other than banks and thrifts in 1986, up from 27.6% in 1970.

Pension contributions also accounted for 51.3% of new individual savings in 1986. While the matter has been subject to debate in the past, the fact is that pension funds do create new savings, according to Laurence J. Kotlikoff, an economic specialist on the issue of pensions in the American economy, who recently spoke on the subject at symposium on Retirement Income Policy sponsored by the APPWP and other groups. Likewise, David Wise has concluded that personal savings are substantially boosted by special retirement savings incentives.

Changes in pension funding patterns also impacts the economy. For example, economists B. Douglas Bernhiem and John B. Shoven, both Stanford University professors, point out that changes in pension contributions by employers in recent years are a reason for declining savings rates. In their 1985 study for the National Bureau of Economic Research (NBER), the two professors cite lower employer pension contributions to corporate plans from 1982-1984 when plan earnings during the stock market boom exceeded actuarial assumptions. Thus the private pension system not only enhances benefit security, it creates affordable domestic capital essential for investment in America's future. To the extent we decrease our ability to save adequately through retirement funds, we increase our need for foreign capital from the savings of our competitors to pay our debts today and thereby mortgage America's future.

## Consuming Our Children: Recent Trends in Benefit Rules

Unfortunately, the private pension system is being undermined by recent federal policy initiatives at the very time it should be bolstered and encouraged. Adequate funding provisions and incentives needed to prepare for the impending retirement of the huge baby boom generation are being choked. And a positive policy climate, established over the last five decades, has been reversed.

The passage of ERISA in 1974 was a watershed event for the private pension system. After nearly a decade of debate, ERISA imposed a structure for sound funding, broader coverage, expanded equity, and guaranteed benefit protection for millions of participants.

Until the early 1980's, the system was, with some fine-tuning, left alone to absorb the enormous impact of ERISA. As a result, the private pension system expanded and thrived during that period; its success can be measured by increased numbers of plan participants, sizable growth in assets, greater security for promised benefits, and increased benefit delivery for current retirees. As the 1980's began, the system was fit and able to respond to the needs of a vastly changing workforce.

Unfortunately, the legislative and political response to the soaring federal deficit has clouded the long-standing policy consensus concerning private pensions. Thus they are more often viewed as tax loopholes draining the the federal treasury and a chief source of revenue to feed today's huge federal debt.

Evidence of this erosion of the private systems strength abounds. Fully 15% of the $280 billion in tax increases levied by the 1986 Tax Reform Act came from pension and other benefits tax changes. New limitations on Section 401(k) savings plans passed as part of the Tax Reform Act have curtailed the positive impact these plans were having on saving by reducing the amounts that can be contributed to these plans. During the past seven years employers have seen the amounts that could be set aside under these plans to fund future benefits significantly reduced.

One anti-savings measure affecting sound pension funding is the erosion of the section 415 limits provided under the tax code. While most legislators regarded these limits as an issue involving the highly compensated employees, section 415 primarily serves as a check on the amount of the pension that can be put aside for workers who retire 30 years from now. By reducing them, we also reduce our ability to provide for these employers.

But perhaps the most disturbing change to the long-run security of the system imposed by recent tax law is the funding limit posed by Omnibus Budget Reconciliation Act of 1987 ("OBRA"). OBRA revised the full funding limitation for qualified defined benefit plans to 150 percent of current liability (essentially the liability the plan would face if terminated today), for years beginning after December 31, 1987. Contributions to plans with funding levels exceeding this amount are nondeductible and subject to the 10 percent excise tax on nondeductible contributions enacted in TRA 86.

These new minimum requirements force faster amortization of accrued liabilities. The new full funding maximum will also further impede plan funding for younger workers by requiring funding to be evaluated on the basis of 150 percent of current liability instead of projected liability. This approach ignores the plan's future asset needs and strips the plan of the ability to save adequately for the future.

Not all the corrosive changes have been legislative. Late in 1985, the Financial Accounting Standards Board (FASB) issued Statement 87, Employers' Accounting for Pensions, effective generally for years beginning after December 31, 1986. Statement 87 requires employers to record benefit liabilities and assets at market value each year for financial statement purposes. Thus, another element of volatility has been introduced in pension expense recorded on financial statements.

These accounting rule changes will likely drive plan sponsors to change investment strategies and shift investments away from long term equity investments to those with shorter time horizons and more predictable returns obtained by fixed income and cash or cash equivalent investments, to make financial statements look positive. In effect, this will reduce the pool of long term investment capital necessary for economic expansion nationwide.

This tendency has not gone unnoticed in Washington. In a recent speech before the Council of Institutional Investors, Deputy Treasury Secretary McPherson decried the lack of long term investment commitment of pension funds. While this may be so from the governmental perspective, investment managers of pension funds are under enormous pressure created by the volatility introduced by legal and accounting rule changes to make steady predictable results in the short run. As Keynes once aptly observed, "In the long run we're all dead." For pension fund managers this is a professional as well as a biological imperative.

Private pension funds could more easily survive the 1987 market crash, due to the adequate provision for funding cushions in the pre-1987 funding law, than the unrealistic funding rule changes imposed by the 1987 budget act. The short-sighted funding rules passed in OBRA 87 will jeopardize the ability to fund adequately benefits for today's workers, and will also erode the financial cushion that safeguards America's pension plans from market swings. Volatile funding and accounting rule changes may also have unforeseen and unfortunate effects on U.S. capital markets and weaken an already depressed U.S. savings rate, now at a forty-year low.

Finally, the law applied to pension and profit sharing plans has become exceedingly complex and often contradictory. The private system has been hit with major tax bills over the last seven years each of which included major pension "reform" legislation. Approximately, one-third of the Tax Reform Act was devoted to employee benefit rule changes. These "seven sisters" have caused many plan sponsors to abandon defined benefit plans, the primary source of investment assets in favor of defined contribution plans or worse, no plans at all. Given the long lead time necessary to assess the impact on the system, it is impossible to determine the damage these changes have wrought, although the data is beginning to appear. IRS recently reported that fully 73 percent of new plans in 1988 were defined contribution plans.

As if this weren't enough, pending legislative proposals seeking to reduce employer access to amounts earned over and above what has been promised to employees. This so-called "reversion" legislation, if enacted, will create a disincentive to employers to fund their plans above the legally required minimum level and is inconsistent with sound pension policy and will deter future defined benefit sponsors from establishing new plans. Moreover, the Congressional Budget Office once again has proposed in 1989 decreasing the amount of contribution levels to retirement and savings plans to almost half of what the level was in 1974!

The end result of these trends, if not reversed, will be the essential unfunding of pension funds. This will have major consequences to individual security, put greater burdens on the federal government to provide increased retirement income, and in the end reduce the positive impact of the private system on national savings just as the first baby-boomers begin to draw down benefits. We must stop consuming the future!

## Its Time to Rethink Our Savings and Retirement Policy

The current course can and should be altered. The APPWP calls for a moratorium on new pension rules and for the establishment of a blue-ribbon commission to establish a coherent, long-term retirement income policy for the United States. Taking a deliberate break from the annual legislative and regulatory blood-letting over pension issues will afford policy makers the time to assess where we are and where we are going. We need to assess not only the role of retirement plans as retirement vehicles but also as plans which provide incentives for individuals as well as corporations to save for other major lifetime expenditures such as medical expenses, housing, etc. We owe it to our future.

Mr. Moody. Thank you very much, both of you have very interesting items. We will make sure every Member receives it, and their staffs will read it for sure and probably forward the most important parts to their Members.

Mr. Weizmann, I was just contacted the other day by someone working with the Hudson Institute on a pension research program and has asked me to get involved. I haven't decided yet to do so. Are you aware of them?

Mr. Weizmann. Generally. Everyone who is concerned about the private pension system is interested in what is happening. I notice that the Hudson Commission is one of those parties. We have recently, WAFL, it is interesting because employer groups and labor groups and the Government have been sitting down and talking about national retirement income policy.

Recently, we cosponsored a retirement income policy forum to talk about the problems inherent in developing a national retirement policy. Certainly the Hudson Institute is a very credible institution, and I would suggest and ask that you do get involved.

Mr. Moody. Certainly, I think if you look at the myriad budget exposures in the out years that the Government has in the pension area and the complexity of it, the fact that they are not coordinated is clear—some people can have as many as three or four pensions. We need to dovetail the systems in addition to the private pension issues that you raise. Somehow, the two should be somehow coordinated.

I was very interested in your comments about the volatility being introduced by the recent changes because we had such a period of underfunding. I guess people thought of it as reform to require the companies to fully fund pensions, but your point is that it should be seen as a floor and not a ceiling, that they should be prohibited from overfunding but should maintain adequate funding for fluctuations in the valued assets in the portfolio. Is that your point?

Mr. Weizmann. Basically, yes. What happened in 1987 is that amortization periods, which used to be 15 years, were shortened to essentially 5 years.

Mr. Moody. It was ill-advised?

Mr. Weizmann. No, I think they are—I think 5 years is probably too short. Fifteen years, conceivably, is too long. The issue is not only in the—on the legislative side, and I want to emphasize it, it is not all legislative, but just something that happened in the accounting profession when these amounts were required to be put on books, on corporate books.

What has happened is that you have financial managers instead of human resource folks being in charge of what, in fact, is the appropriate amount being contributed to pensions.

I noted earlier that one of the economists decried the lessened amount of pension contributions that were going into the plans and what the impacts are. Seventy-three percent in 1988 of all new plans created were defined contribution plans.

I do recognize that the defined benefit plans provide an appropriate level of income replacement, and we need to balance the system. What is currently happening is a lot of major work forces across the country are maturing, but no new defined benefit plans are being put in place to make up for the fact that a lot of these plans no longer have the kind of funding needs that they once had.

Mr. **Moody**. Do you support the idea of portable investing for people who change jobs?

Mr. **Weizmann**. It is a lot like the weather. We all talk about it but first of all, nobody really knows what it is. But portability means to me the ability and facility of carrying a pension that you have earned with one employer to the next employer on into retirement.

If the answer—if that is the portability that we are talking about, then the answer is yes. A lot of people have used portability as a vehicle to, for example, require employers to fund up based on salary increases out into the future which aren't attributable to that employer. That is the particular danger, I think, in the portability area.

If we get into that, then we are going to end up bankrupting the system.

Mr. **Moody**. Thank you both, gentlemen. I appreciate your being here.

The committee stands adjourned.

[Whereupon, at 12:15 p.m., the committee was adjourned.]

[Submissions for the record follow:]

## STATEMENT OF THE AMERICAN ASSOCIATION OF RETIRED PERSONS

The American Association of Retired Persons (AARP) appreciates this opportunity to share its views on the savings rate and its impact on the standard of living for current and future generations. In addition, we will discuss the implications of recent changes in tax policy on tax burdens and shifts in revenue components and their implications for the savings rate. We believe, as you do, that these are issues that warrant serious attention by both policymakers and the general public. We are pleased that the committee has presented these hearings as an opportunity to take a closer view of these policy issues.

### SAVINGS RATE

The U.S. savings rate, which is barely a fourth of the rate in Japan and less than half of the rate of our trading partners in Europe, has fallen markedly in the past decade (see chart). This decline has occurred at every level: in households, firms, and the public sector.

#### Public Sector

The existence of federal budget deficits represents public sector dissaving and adversely affects overall savings, capital formation and productivity. The financing of these deficits has diverted resources that could otherwise flow to more productive investments. The competition for funds from a reduced savings pool has put upward pressure on interest rates, dampening overall investment and living standards in the long-term.

Of course, not all of the public sector accounts are in deficit. In the early 1980's, Social Security faced a financial crisis. Congress and the President agreed on a package of changes to restore solvency to the system well into the next century. This package included some painful measures including increasing payroll taxes and taxing a portion of Social Security benefits. These changes contributed to rapid growth in Social Security trust fund reserves which will be needed when the baby-boomers retire.

It is important to note that the balance in state and local sector accounts impinges on the overall public sector deficit, and state and local governments have accumulated large surpluses in their public pension funds. In addition, their operating budgets are required to be balanced, at least when submitted. A look at recent data from the National Income and Product Accounts suggests that the state/local contribution to saving has declined since 1983, despite growth in public sector pension funds (see table below). A steady increase in state and local social insurance funds since 1983 has been offset by growing deficits in non-social insurance funds, with a resulting decline in public savings.

The federal goverment now has an opportunity to make a serious contribution to future savings through the build up of the Social Security Trust funds. However, these reserves are being used indirectly to finance current government operations instead of investing in productive resources within the economy. The Social Security trust funds can contribute to national savings only if the rest of the federal budget moves toward balance.

The inclusion of the annual increase in the Social Security trust funds in the Gramm-Rudman-Hollings (GRH) deficit calculation is masking an increasing portion of the federal deficit, giving the appearance of greater progress toward deficit reduction than is actually the case. This illusion reduces the pressure on legislators to take the steps necessary to reduce the deficit.

STATE AND LOCAL RECEIPTS, EXPENDITURES AND SURPLUS, 1983-88

| | YEARS | | | | | |
|---|---|---|---|---|---|---|
| | 1983 | 1984 | 1985 | 1986 | 1987 | 1988 |
| Receipts (bil) | $487.7 | 540.5 | 581.8 | 623.0 | 655.7 | 702.6 |
| Expenditures | 440.2 | 475.9 | 516.7 | 561.9 | 602.8 | 647.7 |
| Surplus or def(-) | 47.5 | 64.6 | 65.1 | 61.2 | 52.9 | 54.9 |
| Social insurance | 43.1 | 44.8 | 51.3 | 56.2 | 62.1 | 68.5 |
| Other funds | 4.4 | 19.8 | 13.8 | 5.0 | -9.2 | -13.5 |

Source: Survey of Current Business, Vol. 69, No. 2, February, 1989, 18-20.

---

It is important to point out that reducing the federal budget deficit can be done only by raising revenues and/or reducing spending for non-Social Security related programs. Suggestions that the budget deficit can be reduced by cutting Social Security (through COLA cuts, benefit tax increases, or payroll tax increases) are misleading. Any savings from such measures merely increase the trust fund reserves and further mask the non-OASDI budget deficit.

AARP believes that the removal of the Social Security trust funds from the deficit calculations is appropriate, but their precipitous removal is unwise and could result in economic dislocations harmful to Americans of all ages. AARP favors a smooth and gradual removal of the trust funds from the deficit calculations. If GRH targets are maintained, they should be adjusted upward accordingly. AARP believes that a gradual phasing out of the use of OASDI annual excess of income over outgo in the deficit calculation will force policy makers to respond appropriately to the nation's excess of spending over revenues, without creating potential instability in financial markets. These actions should improve the savings rate in the public sector, making more funds available for investment in the economy, reducing interest rate pressures and encouraging investment.

## Private Sector

While the private savings rate has been showing some signs of strength over the past few months, this may be a temporary phenomenon. Consumers are uncertain about the future growth of the economy, and have cut back on non-essential purchases, thereby raising savings.

Despite the increase in the past few months, the private savings rate over the past few years has shown signs of weakness compared to previous decades. The rate was 4.2 percent in 1988 and a meager 3.3 percent rate in 1987, well below the 9 percent rate experienced in the 1970s. Many factors have been cited as contributing to the decline. One of the major forces behind this decline has been stagnating incomes over the past 15 years. As people earn less, they are able to save less. The data supports this fact with median household income in 1986 below 1973 levels, after adjusting for inflation.

A second reason, often cited in the literature but unsupported by the data, has been a substitution away from private savings towards savings in the form of wealth accumulation. Like the savings rate, however, the rate of growth in wealth has also been on the decline, despite rising home prices and subsequent increases in home equity. While wealth has appeared to be increasing in nominal terms, after adjusting for inflation median household wealth fell 1.4 percent between 1983 and 1986 according to the the Survey of Consumer Finances.

Furthermore, escalating real estate prices have put the American dream of homeownership beyond the reach of many first-time homebuyers. This represents a reduction in opportunities to accumulate savings for retirement in the form of home equity. Such a circumstance is troubling because historically much of American household's wealth has been in the form of homeownership. As households age and move into retirement, many of the liquid assets of net worth are drawn down. Home equity then becomes a major source of net worth for older households, currently comprising over 60 percent of their median net worth (see table). The likely growing popularity of reverse equity mortgages, reinforces a concern for young Americans' prospects for homeownership, because such ownership constitutes a substantial portion of assets held by the public.

Pension funds represent the bulk of household sector savings, yet these are not included in calculations of private savings. However, increasingly these funds are being put at considerable risk as mergers and acquisitions dominate the business community. Protecting the integrity of these assets against corporate raiders ought to be among the highest legislative priorities.

Mounting debt burdens have pre-empted households ability to save. Prior to the 1986 Tax Reform Act, debt financing by consumers was rewarded through a tax deduction. While these incentives toward debt financing by consumers have been phased-out, the debt that has accumulated in response to these incentives still exists.

Different options have been suggested to encourage young and middle-aged Americans to save a greater proportion of their incomes than they are doing at present. One option is indexing of interest earnings on savings for tax purposes so that savers are not penalized for inflation. When households see their savings erode with inflation and then must pay taxes on nominal values, they are more likely to be discouraged from savings. Regardless of the method, the promotion of private savings as a national goal should become a major priority among policymakers.

## Summary

The U. S savings rate is at an all-time low because of large federal budget deficits and the lowest level of private saving in our history. Public sector dissaving is being partially offset by the rapid increase in the Social Security trust funds, but the continuing operating budget deficit is preventing the buildup in these funds from contributing to national savings and productive investment. Removing these trust funds from the deficit calculation would add pressure to reduce the operating budget deficit. Private saving has declined because of a relative decline in private sector income. Household wealth has also declined in real terms.

The decline in private savings in recent years has led some to propose tax policy measures to encourage saving. The "supply side" school of economics argues that reductions in marginal tax rates would spur saving, investment and economic growth. But sharp reductions in marginal tax rates in this decade have done nothing to support this view because they have coincided with the drop in private saving. As a result, taxes are thought to be less important today as influences on the rate of private saving.

Nevertheless, the tax structure which we have today is a reflection of major changes in this decade motivated to a large extent by supply-side thinking. Those changes have influenced the composition of federal revenues, the progressivity of the tax code, individual tax burdens and the level of marginal tax rates.

## TAX BURDENS

Three major features of recent tax policy have influenced the relative tax burdens of Americans in the past decade. One is the relative decline in the revenue contributed by the individual income tax and the relative increase in revenue from the Social Security payroll tax as a percentage of total federal revenue. A second is the reduction in marginal income tax rates which occurred first in Economic Recovery Tax Act (ERTA) and then in Tax Reform Act (TRA) in 1986. A third feature is the elimination of numerous tax preferences in the Tax Reform Act of 1986, including most notably the elimination of the capital gains preference. The first two of these features have made the tax code less progressive than it was a decade ago, the third has made it more progressive.

### The Shift Away From Income Taxes

Between 1980 and 1989, individual and corporate income taxes declined from 60 to 55 percent of total federal revenues, while Social Security taxes increased from 30.5 percent to over 37 percent of federal revenues. These are fairly large shifts in revenue composition in a relatively short period of time.

These shifts in revenue composition have implications for tax burdens of Americans of all ages. Studies by the Congressional Budget Office and the Congressional Research Service suggest that the relative progressivity of the federal individual income tax has shifted over the past 15 years. It became less progressive in the late 1970s and early 1980s, largely due to ERTA, which, had later tax bills not reversed it, would have reduced annual federal receipts by 25 percent. Due to the Tax Reform Act of 1986, the individual income tax has become slightly more progressive again. Although less progressive than it was in the 1970s, the income tax is still our most progressive tax, and shifts in revenue composition away from the income tax make the overall tax structure less progressive.

The payroll tax, in contrast with the income tax, is more neutral distributionally. It is slightly progressive at the low end of the income distribution, because of the Earned Income Tax Credit and because a higher percentage of the income of low-income people comes from transfers than for higher income people. It is regressive at the high end because it is capped and is limited to earned income, which is a smaller percentage of the income of high-income persons.

According to the Congressional Budget Office, between 1977 and 1988 the effective income tax rate (the ratio of income taxes to family income) for all families declined from 11.1 percent to 10.4 percent, while effective Social Security tax rates (the ratio of Social Security taxes to family income) increased from 6.2 to 8.7 percent (see table below). While the combined burdens of these two taxes have increased for all income deciles, they have increased more for those in the lower income deciles, have not increased at all for the top five percent, and have decreased for the top one percent of the income distribution.

As a result of reduced income tax rates and increased payroll tax rates, the effective payroll tax rate in 1988 is greater than the effective income tax rate for all but one-tenth of the population, compared with forty percent in 1977, according to CBO. In other words, ninety percent of the population has a higher payroll tax burden than its federal income tax burden.

## EFFECTIVE FEDERAL TAX RATES BY POPULATION DECILE, WITH CONSTANT 1988 INCOMES

| Decile | Individual Income Tax | Social Insurance Taxes | Total |
|---|---|---|---|
| | Income-Indexed 1977 Tax Law | | |
| First | -0.6 | 3.7 | 3.1 |
| Second | -0.7 | 4.2 | 3.5 |
| Third | 1.2 | 6.3 | 7.5 |
| Fourth | 3.7 | 7.1 | 10.8 |
| Fifth | 5.6 | 7.6 | 13.2 |
| Sixth | 7.0 | 7.8 | 14.8 |
| Seventh | 8.4 | 7.9 | 16.3 |
| Eighth | 9.7 | 7.8 | 17.5 |
| Ninth | 11.2 | 7.1 | 18.3 |
| Tenth | 17.3 | 4.0 | 21.3 |
| Top five percent | 19.4 | 2.9 | 22.3 |
| Top one percent | 24.3 | 1.1 | 25.4 |
| All deciles | 11.1 | 6.2 | 17.3 |
| | Actual 1988 Tax Law | | |
| First | -0.8 | 4.7 | 3.9 |
| Second | -0.5 | 5.3 | 4.8 |
| Third | 1.5 | 8.0 | 9.5 |
| Fourth | 4.0 | 9.0 | 13.0 |
| Fifth | 5.8 | 9.6 | 15.4 |
| Sixth | 7.1 | 10.0 | 17.1 |
| Seventh | 8.2 | 10.3 | 18.5 |
| Eighth | 8.9 | 10.8 | 19.7 |
| Ninth | 10.3 | 10.5 | 20.8 |
| Tenth | 15.8 | 6.3 | 22.1 |
| Top five percent | 17.5 | 4.8 | 22.3 |
| Top one percent | 20.9 | 1.9 | 22.8 |
| All deciles | 10.4 | 8.7 | 19.1 |

Source: Congressional Budget Office, The Changing Distribution of Federal Taxes: 1975-1990, October 1987, Table 12.

Although the composition of revenue has changed, federal revenue collections as a percentage of GNP are the same in 1989 (19.4 percent) as they were at the beginning of the decade, down from a high of 20.1 percent in 1981. Were it not for the tax changes of 1981 that limited the responsiveness of federal revenues to the economy, revenues would have grown to 22.4 percent of GNP by 1989. Instead, they are projected to remain at the current level for the next several years, despite federal outlays that are projected to be between 22 and 23 percent of GNP. This means a continuing structural deficit of between two and three percent of GNP unless action is taken to raise taxes and/or reduce spending.

We believe that federal revenues must be restored to a fiscally prudent level, which means that additional taxes are needed. We also believe that some progressivity should be restored to our tax structure. Additional revenues for deficit reduction should therefore be obtained as progressively as possible, preferably through increased compliance with the income tax laws, closing corporate income tax preferences such as those for business entertainment, advertising, and debt incurred in leveraged buyouts, and extending the highest marginal rate of 33 percent rate to apply to the highest income taxpayers (for whom it is now 28 percent). Non-income tax increases could come from reforms of the estate tax or increases in excise taxes which, despite their regressivity, command substantial popular support and accomplish desirable non-revenue ends.

## Lower Marginal Tax Rates

The "supply-side revolution" in tax policy was premised on the idea that high marginal tax rates discouraged people from working, saving and investing, and that the secret to spurring investment and economic growth was significant drops in marginal tax rates. This new policy was ushered in with the Economic Recovery Tax Act of 1981, which reduced tax rates by 23 percent across the board for individuals and also reduced corporate tax burdens through rate reductions, generous depreciation rules, and an expanded investment tax credit.

The Tax Reform Act of 1986 further reduced marginal tax rates across the board, and reduced the number of brackets from 14 to two, with an effective third rate resulting from a surcharge on certain upper-middle-income taxpayers. In a period of seven years, top marginal income tax rates dropped by nearly two-thirds, from 70 percent to 28 percent. Yet, after seven years' experience with sharp reductions in marginal tax rates, we have seen a decline in private savings to its lowest point in our history. Our sustained growth for nearly seven years has been financed by borrowing from other nations and amassing an additional $2 trillion in gross federal debt. The lack of any improvement in private saving in this decade suggests that the effect of reducing marginal tax rates has been exaggerated.

During the period that most Americans have benefited from lower statutory marginal tax rates, a variety of provisions in the law have caused certain groups of taxpayers to face much higher effective marginal tax rates (as opposed to the nominal rates in the law) than the rest of the population. Older Americans have recently been singled out in the media as the group "the supply-side revolution forgot." Because of the taxation of Social Security benefits, as well as the exposure of some older persons to the Social Security earnings limit and the costs of the new Medicare Catastrophic Supplemental premium, some older Americans are facing what a few economists call extraordinarily high marginal tax rates, even though the latter two are not taxes. Average tax rates for older Americans remain low by comparison with other taxpayers, but there is a concern that the marginal rates serve as disincentives at a time when America needs greater productivity.

We recognize that high marginal rates do not affect a majority of older persons, since only twenty percent have any earned income, and since only about the same percentage pay any tax on their Social Security benefits. At the same time, we are concerned that high marginal tax rates may discourage many older persons from working and investing, which we as a nation cannot afford. Furthermore, the provisions creating these high rates are concentrated on roughly the same middle-income ranges of the older population--single persons with incomes of $20,000 to $30,000, and married couples with incomes of $30,000 to $40,000--where the burden is felt quite acutely.

While marginal tax rates have come down in the last several years for most taxpayers, those for some middle-income older persons have increased. Despite this fact, some have proposed that we increase the taxation of Social Security benefits. Proposals to further tax Social Security benefits by increasing the percentage of benefits subject to tax or by lowering the income thresholds will only make the already high marginal rates even higher, or subject a larger proportion of the retired population under the current tax thresholds to these higher marginal rates. For these reasons, as well as continuing and projected solvency of the Social Security trust funds, we oppose any measures to increase the taxation of Social Security benefits.

## The Elimination of Tax Preferences

The Tax Reform Act of 1986 made sweeping changes in the tax law which affected all Americans. The best features of that law were the increased protections against taxation for low income persons through increased personal exemptions, standard deductions, Earned Income Tax Credit and the indexing of all those provisions. These had the effect of increasing progressivity.

The Tax Reform Act reduced numerous individual tax preferences in order to bring down marginal rates, including the phase-out of interest deductions, limitations on IRAs, higher thresholds for medical and miscellaneous deductions, elimination of the two-earner deduction, elimination of the dividend exclusion, and the elimination of the 60 percent capital gains exclusion.

Elimination of the capital gains preference created an important tax increase in the Tax Reform Act. Eliminating the capital gains preference raised the top marginal tax rate on capital gains from 20 to 33 percent. This tax increase particularly affects those with more capital assets. Older Americans, who have worked longer and provided for income security in their retirement years, have generally accumulated more capital assets than the rest of the population. Much of these gains are due to inflation alone, rather than real increases in value. As a result, many middle-and upper-income older persons paid increased income tax after tax reform due largely to inflationary gains on capital assets.

Several independent analyses have borne this out. An analysis using the Urban Institute TRIM model estimated that taxes paid by the nonelderly declined by eight percent due to tax reform, whereas the elderly as a whole paid three percent more taxes, although more families paid lower taxes than paid higher taxes. Since those at the very lowest income levels were moved off the tax rolls entirely, this means that tax increases for higher-income people were substantial.

AARP supported tax reform because it was a progressive measure which removed millions of low-income people from the tax rolls entirely. At the same time, many older Americans who paid higher taxes did so because of increases in capital gains directly attributable to inflation in long-held assets, which we believe is unfair. We do not support measures to reintroduce a capital gains tax preference through a reduced capital gains rate, but we support indexing the basis of assets held for long periods (perhaps ten years or more), so that gains due solely to inflation are not taxed. This reform would merely treat this income source like other income which is protected by indexing provisions against the eroding effects of inflation.

## Conclusion

Recent tax changes have shifted the composition of federal revenues in a less progressive direction. Revenues have also fallen below a fiscally prudent level. AARP believes that federal revenues should be increased. Priority should be given to measures such as increased compliance with the income tax, limitation of corporate tax preferences for entertainment, advertising and debt incurred in leveraged buyouts and extending the top 33 percent rate to all high-income taxpayers. Reforms in the estate tax and increased excise taxes should also be pursued. As a measure of tax equity, capital assets held for a long period should be indexed for inflation.

Statement of

The American Council of Life Insurance

on

the Impact of Life Insurance and Pensions on

Saving and Economic Growth

to

the Committee on Ways and Means

U. S. House of Representatives

May 19, 1989

This Statement is submitted by the American Council of Life Insurance to the Committee on Ways and Means for the record of the hearings on the U.S. saving rate held April 19-20, 1989. Its purpose is to make the Committee aware that life insurance and private pensions are an important source of national saving and of long-term investment. The American Council of Life Insurance is the major trade association for the life insurance business, representing 640 life insurance companies. Together, these companies hold approximately 93 percent of the assets of all United States life insurance companies and 97 percent of the reserves for insured pension plans.

We strongly agree with the premise of the hearing announcement that the Committee's hearing process should provide the opportunity for Members to consider economic trends in a context other than the fiscal emergencies of budget deadlines. Taking the time to reflect on our nation's long term economic needs should provide valuable insight into the direction of long term tax policy that best fits with our nation's goals. In recent years tax changes have frequently been driven by the budgetary needs of the reconciliation process. We believe that these hearings should provide the foundation for a careful balancing of the gains to our economic health from a reduced deficit with any negative economic impact caused by specific deficit reduction proposals. We believe deficit reduction proposals which would have an adverse impact on saving and capital formation clearly produce a negative balance and should not be adopted.

In that regard, the backbone of the life insurance business is the provision of long-term financial protection and saving. In so doing, the business accumulates, through permanent insurance and pension products, large amounts of personal saving which go directly into private capital formation. Moreover, this saving is particularly well suited to supplying funds for long term investment in plant and equipment, including commercial structures. Tax changes which would discourage this form of personal saving would seriously damage our ability to finance the growth of our economy with domestic saving and would force greater reliance on foreign capital. Thus, any such changes in the name of deficit reduction would be counter productive and should be avoided.

## The Impact of Life Insurance and Pensions on Savings and Economic Growth

### U.S. Saving Rate Too Low

It is widely recognized that our rate of net national saving (saving in excess of depreciation) needs to be increased and clearly not discouraged. Net national saving has declined from a rate of more than 7 percent of the Gross National Product (GNP) in the 1960s and 1970s to a rate of less than 3 percent of the GNP in 1988. The desirability of a higher rate of net national saving is undisputed. This is the domestic source for financing the expansion and improvement in the income-producing capital base our economic growth and well being is founded on.

In recent years, the expansion and improvement in that capital base (net domestic investment) has been stronger than our net national saving would allow. We have had to rely on savings from foreign sources. In fact, in 1988, U.S. net national capital needed an additional amount equivalent to 3.8 percent of GNP to be contributed from foreign sources to finance net domestic investment at a rate of 5.4 percent of GNP. Even with the foreign infusion, this 5.4 percent of GNP net domestic investment is below the average rates of net domestic investment of the previous two decades.

## Life Insurance and Pension Savings are a Significant Part of National Savings

The personal saving by individuals, including saving done in their behalf by employers through contributions to pension plans, is a major source of our net national saving. Savings through life insurance and private pensions have, in turn, historically been a significant component of personal savings, and in recent years, have grown relatively more important. As seen in Chart 1, life insurance and private pensions contributed $160 billion of personal saving in 1988. As can be seen in Chart 2, this source of saving is now one of the three dominant and approximately equal components that make up the bulk of personal saving (the other two are securities and time and savings deposits).

## Unique Role of Life Insurance and Pension Reserves in Capital Formation

Life insurance and private pension reserves represent a unique pool of savings. The needs met by life insurance and private pensions are inherently long-term. People save through these vehicles with their eyes on the horizon. Moreover, private pensions and life insurance offer a highly structured, stable and dependable means of saving for those long term needs. It is possible, and indeed desirable to match these funds with long term investments in corporate plant and equipment and commercial construction, a vital sector if the U.S. is going to improve its productivity and keep its place as a leader in the world economy.

In fact, 62 percent of all financial assets of life insurance companies and private pension funds were invested in corporate bonds, commercial mortgages and corporate equities at the end of 1988. Life insurance and private pension funds together at the end of 1988 held 47 percent of all corporate bonds outstanding in the U.S., as can be seen in Chart 3. Chart 4, which breaks down commercial mortgages by sector, shows that life insurance companies and private pensions held 27 percent of all commercial mortgages at the end of 1988. Finally, Chart 5 shows the life insurance and private pension sector with 19% of the holdings of corporate stock at the end of 1988.

Because of the natural matching of long-term savings to long-term investment, the insurance and pension business has an expertise and a preference relative to other financial intermediaries for investments in plant and equipment, lowering the cost of capital for these investments from what it otherwise would be.

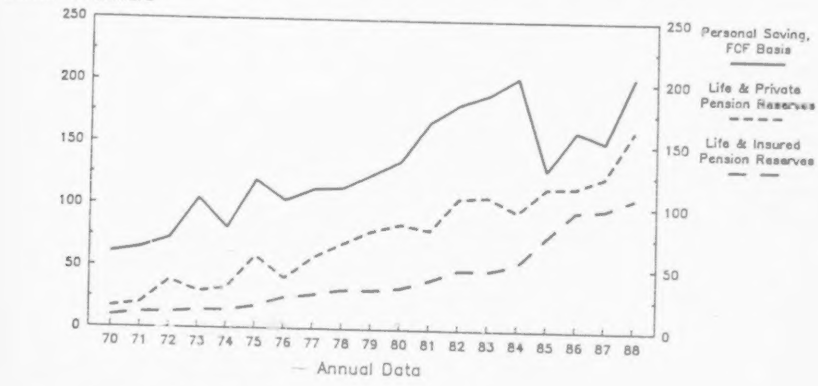
No one disputes that an increased rate of domestic investment in plant and equipment translates directly into an increased competitiveness of the United States in world trade.

## Summary

It is imperative that tax policy decisions be congruent with the economic and social policy goals that are determined to be the top priorities for our national well-being. Net national saving is widely recognized as being too low and in need of strengthening. Savings through life insurance and private pensions make up a large, growing component of national savings and have the special characteristic of being ideally suited to long term investments to finance corporate capital spending and commercial construction. Thus, tax changes that adversely impact life insurance and private pensions would cause immediate and direct damage to our net national saving, would inhibit our ability to modernize our industrial plant and equipment and would be in direct contradiction with our economic goals.

Chart 1

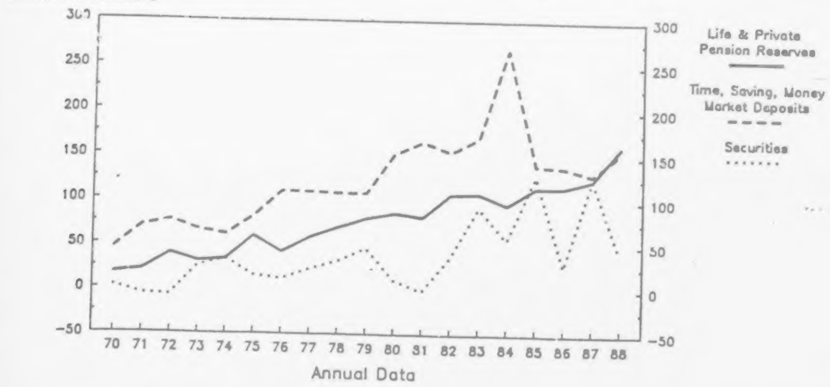
Growth in Life Insurance & Private Pension Reserves Compared With Private Saving



Source: Federal Reserve Board, Flow of Funds

Chart 2

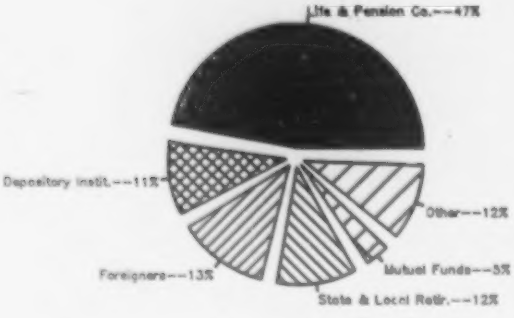
Major Components of Personal Saving



Source: Federal Reserve Board, Flow of Funds

Chart 3

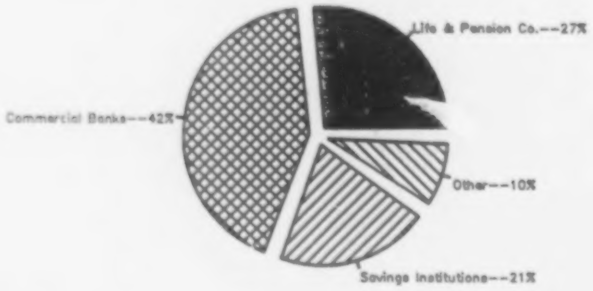
## Corporate Bond Holdings by Sector
1988



Source: Federal Reserve Board, Flow of Funds

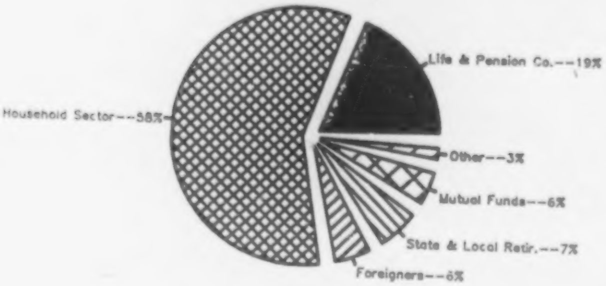
Chart 4

## Commercial Mortgage Holdings by Sector
1988



Source: Federal Reserve Board, Flow of Funds

Chart 5
Corporate Stock Holdings by Sector
1988



Source: Federal Reserve Board, Flow of Funds

# TESTIMONY OF ROBERT GREENSTEIN
# DIRECTOR, CENTER ON BUDGET AND POLICY PRIORITIES

**before the**

**HOUSE COMMITTEE ON WAYS AND MEANS**

**April 19, 1989**

I appreciate the opportunity to submit testimony for the record to the Committee on Ways and Means. The Center on Budget and Policy Priorities is a non-profit organization that conducts research and analysis on public policy issues, with an emphasis both on fiscal issues and on a range of policy issues that relate to low and moderate income Americans. The Center is funded primarily by foundations.

As many witnesses at these hearings have said, the savings rate in the U.S. is too low, and the budget deficit too high. The key to the future health of the American economy is to boost productivity. To do so requires adequate investment, yet the large deficit we now face makes it difficult to secure the scale of investment needed in either the private or the public sector. As a result, strong steps to reduce the deficit -- and thereby to increase the funds available for needed investments -- should be among our top priorities. Such steps will necessarily entail both revenue increases and spending reductions if they are to be of a sufficient magnitude to make a sizable dent in our deficit problem. While the new budget agreement means that such steps will largely be postponed until next year, the groundwork for such steps can start to be laid now.

As we begin to think of measures to help increase the savings rate, boost productivity, and promote economic growth, we should, however, not lose sight of how such measures would affect income distribution in the United States. In particular, as the Congress begins to craft deficit reduction measures of a large magnitude, questions of balance and equity should be accorded considerable weight. Balance should not simply mean an appropriate mix of spending cuts and tax increases. Balance must also include consideration of how the required sacrifices are distributed across various income groups, from the poorest to the wealthiest. Both spending cuts and revenue increases can be designed that are progressive -- or regressive -- in their effects.

Distributional questions are especially important because over the past two decades, income inequality has widened in our nation -- and the gaps between both top and bottom and top and middle have grown. The evidence that inequality has been on the increase is extremely strong. Each year, the Census Bureau publishes data on how the national family income is divided. The data show that in 1987, the wealthiest 40 percent of American families received a larger share of the national income than in any other year since the Census Bureau first began collecting these data in 1947. At the same time, the bottom 40 percent of American families received a smaller slice of the national income than in any other year on record except for 1986, a year in which they received the same record low share as in 1987. Similarly, in 1987, the share of the national income going to the 20 percent of American families right in the middle of the income spectrum was the second lowest level that has been recorded. The lowest level for this group came in 1986.

In short, the Census data show that in 1986 and 1987, the gaps between wealthy families and poor families -- and also between wealthy families and those right in the middle of the income spectrum -- were greater than at any time since the end of World War II.

As data compiled by the Congressional Budget Office and published in the Committee's "Green Book" indicate, inequality has been growing at a more rapid rate since the late 1970s. For affluent families, average incomes have increased. For those in the middle of the income spectrum, average family incomes have stayed roughly the same. And for those on the lower rungs of the economic ladder, average family income has plummeted.

Most disturbing are the data on income trends among families with children. In just eight years from 1979 to 1987, the average family income of the poorest fifth of families with children plunged more than 20 percent in inflation-adjusted terms. The average income of the next-to-the-poorest fifth of families also fell significantly. But the top fifth of families with children fared extremely well, experiencing an average income increase of more than 11 percent or more than $7,000 per year.

These sharp income drops among poor families are reflected in, and help explain, the surprisingly high rates of poverty that persist amidst economic recovery. In 1987, the fifth year of an economic recovery, the poverty rate was significantly higher than in any year of the 1970s, including the deepest recession years of the 1970s.

The declining fortunes of poor families with children are similarly reflected in the child poverty rates. One of every five children lives in poverty despite the economic recovery. Moreover, those children who are poor have, on average, grown poorer.

Consider, for example, children who fall into a category we might term "the poorest of the poor" -- those with family incomes below *half* of the poverty line. (In 1987, a family of three falling below half the poverty line had income of less than $4,528.) In recent years, the number of children falling into the ranks of the poorest of the poor has exploded. From 1978 to 1987 the number of such children rose by 66 percent, increasing by 54 percent among black children and by 69 percent among white children.

Indeed, in 1987, two of every five Americans of all ages (or nearly 13 million people) fell into the ranks of the poorest of the poor. This represented the largest such proportion in more than a decade.

### Factors Behind these Increases in Poverty

Some may dismiss the data just cited as being largely a result of increases in the proportion of families headed by a single woman. Yet while changes in family structure have clearly contributed to increasing poverty and growing inequality, it would be a mistake to assume that such demographic developments are the principal cause of these trends. From 1978 to 1987, the increase in the number of poor people living in two-parent families was *greater* than the increase in the number of the poor living in single-parent families.

While demographic factors have played a role, economic and public policy changes have also been very important. (Data in the "Green Book" indicate that economic and public policy changes have been the paramount causes of the increase in poverty since the late 1970s, playing a substantially larger role during this period than demographic factors.) On the economic front, the gaps between the compensation paid for high and low-wage paying jobs have grown sharply, and wages for low-paying jobs have eroded substantially. In 1987, the average hourly earnings of private nonsupervisory workers were lower than in any other year of the 1970s or 1980s, after adjustment for inflation.

Wages have fallen especially sharply among minority workers, and particularly minority men. Median weekly earnings of black men working full-time were 10 percent lower in 1987 than they had been in 1979 -- a decline of $39 a week (or $2,000 on an annual basis). Median weekly earnings of Hispanic men working full-time were 13 percent lower in 1987 than in 1979, a drop of $49 a week (or more than $2,500 on an annual basis). These declines in wages help to explain why minority family income was lower in 1987 than in the late 1970s, despite the reductions in recent years in the black and Hispanic unemployment rates.

### Changes in Government Policies

In addition, changes in government policies have played a substantial role in increasing poverty and inequality. This is reflected in Census data that tell us how many families were poor both *before*, and *after*, receipt of government benefits. These data show, for each year since 1979, the proportion of poor families with children that was lifted out of poverty by government assistance.

The data tell us that in 1979, nearly one in five (18.9 percent) of all poor families with children was lifted out of poverty by government benefits. This was hardly a large percentage to begin with. But by 1987, only about one in ten (10.5 percent) of all poor families with children was lifted out of poverty by government benefits. The impact of government programs in removing poor families with children from poverty had been cut nearly in half.

During this period, retrenchments in benefits programs occurred at all levels of government. The states allowed benefit levels in the Aid to Families with Dependent Children (AFDC) program to decline sharply in purchasing power. In addition, the federal budget reductions of the early 1980s cut deepest (in percentage terms) into means-tested benefit programs such as AFDC and food stamps. As a result of changes in AFDC at both federal and state levels, the program experienced substantial contraction. In 1977, there were 76 children on AFDC for every 100 children below the poverty line. In 1987, there were 56 children on AFDC for every 100 below the poverty line.

Similarly, in 1976, a single-parent family of four with earnings equal to 75 percent of the poverty line qualified for AFDC in 46 states -- and received benefits (including food stamps) that lifted it above the poverty line in 45 states. Today such a family is eligible for AFDC in five states and is lifted above the poverty line in only one.

Retrenchments at both federal and state levels have also been substantial in the unemployment insurance program. For five consecutive years from 1984 through 1988, the proportion of the unemployed receiving unemployment insurance benefits hit a new record low or tied the previous low. In both 1987 and 1988, 31.5 percent of the unemployed -- or fewer than one in three -- received unemployment benefits in the average month.

These data should give us pause. They illustrate that at a time when underlying trends in the private economy were already widening the gaps between rich and poor, public policy -- rather than seeking to ameliorate these trends -- served to accelerate them.

Consequently, as we search for ways to reduce the deficit and increase the national savings rate, it is incumbent upon us to eschew policies that would further increase poverty and inequality. That increasing inequality and poverty are *not* necessary components of a healthy and growing economy can be seen by looking at our foreign competitors. The degree of income inequality and the rate of poverty is now greater in the U.S. than in nearly all other western industrialized countries that compete with us in the global marketplace.

### Sources for New Revenues

If we are to achieve substantial reductions in the deficit in the years ahead, increased revenues will have to be a major element of a large-scale deficit reduction package. Increased revenues can serve both to constrain consumption and to reduce the deficit. Yet there are various options for how to raise revenues. As these options are considered, distributional questions should be kept in mind. Given the increases in poverty and inequality since the 1970s, we should take care to ensure that new revenue measures do not push low income households deeper into poverty or further widen gaps between rich and poor.

This argues for progressive revenue-raising measures such as base-broadeners, and even for some reexamination of the rate structure. Base-broadeners can have a double benefit -- they not only raise revenue, but they can strengthen the economy and improve the quality of the stock of investment capital by further "levelling the playing field" and helping to assure that capital is invested in accordance with economic rather than tax considerations. After all, the basic issue here is not simply to have a savings rate that supplies an adequate amount of investment capital, but also to assure that capital is not allocated inefficiently and diverted to relatively unproductive purposes as a result of tax considerations. While the Tax Reform Act of 1986 made major strides in broadening the tax base, more base broadening can be done in a number of tax areas.

In addition, the rate structure -- in particular, the "bubble" under which the wealthiest taxpayers have a lower marginal tax rate than many taxpayers less affluent than themselves -- should also be reexamined.

Several witnesses at these hearings are likely to argue that forms of taxation such as a value-added tax, rather than income taxes, should provide most of the revenues to be raised. They are also likely to contend that such a tax can be designed in a fashion that eliminates its regressivity and shields those at the bottom of the income spectrum from being subjected to increased tax burdens that can push them into (or deeper into) poverty.

I would have to express a fair measure of skepticism concerning this argument. For a number of months, our staff at the Center on Budget and Policy Priorities has been examining possible options to "offset" the regressive effects of consumption taxes and to protect low income families. Our findings are not encouraging.

One of the most frequently mentioned "offsets" to a regressive consumption tax, for example, is an expansion in the Earned Income Tax Credit. As the Committee may know, the Center on Budget and Policy Priorities has long been among the leading exponents in Washington of an expansion in the credit. We worked with the Chairman and the Committee in 1986 in their efforts to enlarge the credit as part of tax reform. More recently, we have been urging an expansion of the credit to reflect the number of children in a family. We are particularly impressed by legislation to expand the credit in this manner that has recently been introduced by Rep. Tom Downey, and also by legislation introduced by Rep. Thomas Petri. If the Committee enacts a large regressive tax (which we do not recommend), it would make sense to include EITC legislation such as this in the revenue package. However, and this is my point, an expansion of the earned income credit is not adequate as an offset to a regressive tax. Fewer than one in every four households below the poverty line qualifies for the earned income credit. It does not reach poor households without earnings -- such as the elderly, the disabled, the unemployed, and single parents with young children -- and it does not reach those poor workers who are without children or whose children do not live at home. As a result, many poor households burdened by a regressive tax increase -- including poor households that work and already bear high payroll taxes but that do not qualify for any EITC benefits to ease their payroll tax burdens -- would be taxed deeper into poverty as a result of such a revenue-raising measure.

An alternative that has been suggested by some proponents of a value-added tax is to institute a new refundable tax credit for which all low income households would qualify, whether or not they had earnings or children. The new credit would be designed to refund the taxes that would be collected from such households under a value-added tax or similar tax scheme.

On paper, such an approach may sound appealing. In practice, it has serious shortcomings. First, such a credit would reach only those households that file for it. More than half of all households living in poverty do not have earnings, and most such households without earnings do not file a tax return. Reaching such households would be difficult; many of them would be unlikely to file for this new tax credit.

That this would likely be the case is borne out by the experiences of state governments. While there is no federal experience with broad-based refundable tax credits for low income households that cover all age groups and types of families and that include both those with and those without earnings, a number of states have tax credits of this nature. More than 30 states have low income refundable tax credits that are available to some categories of households that have no earnings and would not otherwise file a tax return.

The general experience of these states is that the proportion of low income households that are without earnings and thus would not normally file a tax return -- but that do file for and receive a state refundable tax credit -- is low. Households that do not file a state income tax return often do not file for the refundable credit, either.

Kansas' Food Sales Tax Refund Program is a case in point. The program provides a refund (as an offset to sales taxes on food purchases) for low income households (generally those with incomes up to $13,000) that have an elderly, blind, or disabled member or a dependent child under 18 years of age. Kansas officials have estimated 246,000 households to be eligible for the credit (in 1986). Some 83,300 households participated and received credit benefits last year -- only about one-third of those estimated to be eligible.

A counter example sometimes offered by proponents of this approach is the high participation rate reported by New Mexico officials for their state's Low Income Comprehensive Tax Credit. Whether the participation rate is as high in New Mexico as is claimed is questionable, due to discrepancies in the data used to estimate the eligible population. More important, in New Mexico the state instituted a massive outreach effort, which included the conduct of field hearings across the state and the hiring of agents for every field office to assist residents in filling out credit applications. New Mexico has one such field office *for every 10,000 recipients of the credit*, a model clearly not applicable at the federal level. (Indeed, New Mexico officials attribute the high participation rate partly to the small size of the state's population.)

This should call attention to another problem with the proposals to create a new refundable tax credit for earners and non-earners alike -- the potential administrative problems of administering such a credit. It is unclear how IRS would check the income levels of applicants who lack earnings and have no W-2 forms. This would be particularly important if credit benefit levels were to fall as income rose.

Proposals to offset regressivity by exempting certain necessities from a value-added tax would not be likely to work well either. While necessities such as food, housing, and health care costs take up a significant portion of the expenditures of poor households, they also constitute a significant proportion of the expenditures of higher-income households. It has been estimated that food, shelter, and health care costs consume about 60 percent of total consumption of the poorest fifth of households, but about 50 percent of the consumption of the top fifth of households. Thus, exempting necessities from a value-added tax would be both inefficient and largely ineffective as a way to reduce the regressivity of such a tax. Moreover, once the door is opened to exemptions to such a tax, there is no way to know where the exemptions will end. The result can be a complicated, inequitable, and still regressive tax mechanism.

In short, there appears to be no good way to offset fully the regressive effects of value-added taxes or to shield fully those at the bottom of the income scale from the effects of such taxes. The best "offset approach" would probably be to combine a large increase in the earned income credit (for working families with children) with an increase in SSI benefits (for the elderly and disabled) and an increase in food stamp benefits (for non-elderly or disabled households ineligible for the EITC, such as single-parent families with children). Such an approach clearly has drawbacks as an "offset" strategy. Some substantial number of low income households would still be left out, while some others would benefit from more than one such offset.

Moreover, if the idea behind an expansion of the earned income credit is to help ensure that families that work full-time do not have to live in poverty, this goal is not attained by taking as much out of the pockets of the working poor through increased consumption taxes as is put back through an expanded earned income credit. The approach reflected in Rep. Downey's bill -- of financing an expanded earned income credit by eliminating the "bubble" in the top income tax rate -- is superior.

In short, a value-added tax should be a last resort, not a first resort. Before considering such an approach, we should look to other income sources from which revenues can still be raised in a progressive manner, such as the income tax and the estate tax. New forms of regressive taxation should not be instituted while loopholes remain to be closed -- especially when the U.S. continues to have higher rates of poverty and inequality than nearly all of its principal competitors.

As part of an effort to raise new revenues, we should look to increased taxation of those in the upper parts of the income scale. These are the people whose income has shot upward in recent years and who have benefitted most from recent economic trends and public policies both. In fashioning our tax policies over the next several years, we should take cognizance of the fact that the income distribution has widened significantly to the detriment of those at the bottom, and we should design new policies accordingly.

WALNUT 2-5252

GEORGE ROSS FISHER, M. D.
829 SPRUCE STREET
PHILADELPHIA, PA. 19107

April 19, 1989

Dan Rostenkowski, Chairman
Committee on Ways and Means
U.S. House of Representatives

Mr. Chairman,

**Re: Using Health Insurance to Increase the Nation's Savings**

These hearings were called to examine the nation's collective rate of private savings, reflecting concerns that superior economic performance by certain foreign countries may partly be caused by their greater savings rates. I am not qualified to judge such matters; this testimony accepts it would be useful for the nation to increase its collective investment pool. My proposal is that this committee could cause substantial increase in the investment pool through enactment of some revenue-neutral tax law liberalizations, relating to health insurance.

* * *

For persons from birth to age 65, the organizational form of health insurance is almost entirely an outgrowth of the tax laws.

**Because:**

> Employees are not required to pay income tax on money used to purchase their health insurance, so long as their employer buys it for them,
>
> And the purchase of health insurance by any other method must be paid for with after-tax dollars,
>
> And employers are permitted to reduce their own income tax by treating such in-kind employee remuneration as a business expense,
>
> It would then seem silly for employees to purchase health insurance in any other way, and silly for employers to provide taxable cash remuneration rather than tax-exempt benefits.

The remuneration system has responded massively to this set of tax incentives. The preponderant bulk of health insurance for persons under age 65 is in the form of employer-based group health plans. There are a number of advantages to this uniquely American system, primarily the provision of health insurance to persons who might not be wise enough to buy it out of discretionary income. There are also a number of disadvantages to the system, primarily the international competitive disadvantage it imposes on American industry to have employee personal expenses forcibly included in the cost of manufacture.

**Existing Limitations of Law.** But the main disadvantage of the system for the purpose of increasing the national savings rate is not inherent in the employer group health insurance system, but is rather a product of some traditional rules and rulings which have become attached to it. Somehow the courts and regulatory bodies appear uncomfortable (without express Congressional sanction) with acknowledging that this tax abatement was an inducement to people to buy something they really should have been provident enough to buy without such added incentive. Instead, health care has been treated as preventative maintenance of an employer's necessary asset, his employee. Seemingly following some such reasoning, an employer is not permitted to prefund or carry health benefits over from year to year. As a consequence, employer-based group health insurance buys only a current year's health expenses in a collective way, sometimes referred to as "pay as you go". Looked at in another way, group health insurance takes a form analagous to "term" life insurance. It is, in short, unfunded.

> **Other Advantages of Prefunding.** Since the subject of today's hearing is the search for ways to increase investment funding rather than to deliberate how people should best spend their investment proceeds, it may not be entirely germain to tout the considerably reduced cost of health insurance and health care which would result from the infusion of compound interest into the funding of health insurance. Or to tout the increased portability of such funded insurance for the employee as he moves between employers. Or to reflect upon how many fewer persons would lack health insurance coverage during the intervals when they are unemployed. However, since the law of unintended consequences applies to this proposal as it does to any other, the good consequences must be mentioned for balance.

**Duration of Investment.** For the purpose of visualizing the investment pool which could result from actually encouraging the prefunding of health insurance, consider briefly the shape of average lifetime health costs. A cartoon of the average cost would resemble a dumbell, portraying heavy costs associated with birth and early childhood, heavy costs associated with the process of dying, but comparatively modest average health costs in the many years between birthing and death. From the employer's point of view, the cartoon is modified by the absorbtion of most death costs by Medicare after the termination of active employment, qualified in turn by whatever retirement health benefits may be provided. For the present, we can avoid such tangles to concentrate on the point that there are many years of low health care expenditure within the average employees career, during which time compound interest could be building up to help pay for the rainy day. It is not excessive to project a trillion dollars eventually resting in such a funding pool. I leave economists to conjecture what such a pool would mean to American enterprise, banking, interest rates, inflation and balance of international payments.

Although the insurance industry does sometimes dismay me with lack of statesmanship, I have nothing but admiration for their ability to devise ingenious technical methods for selling their products and reducing their administrative costs. They can probably think of better ways to achieve funded health insurance than the one I am about to propose, but they have not yet done so, and therefore I venture to propose the IRA for Health.

> **The proposal to fund health insurance would be:**
>
> Either employers (treating it as a business expense) or individuals would be permitted to make tax-exempt contributions to individual IRAs, up to the amount of the annual premium for full first-dollar health insurance.
>
> And, IRAs would be permitted to purchase, without tax, health insurance for the individual with copayment and deductible features at lesser cost, retaining the difference as an investment fund.
>
> And, when the investment fund grew to the point where its investment income equalled the premium of the health insurance, further withdrawals for specified purposes would be permitted without penalty.

Just about everyone understands the principles involved in the Individual Retirement Account, including tax deductibility of the contribution, tax sheltering of the investment growth until the time of withdrawal, and the 10% penalty for early withdrawal. To use the IRA to fund health insurance, the 10% penalty for early withdrawals is a severe impediment , and that rule — mainly imposed at the behest of bankers, I understand — must be appropriately modified. Furthermore, people are not interested in accumulating money they cannot spend, and if their funds generate a profit, it must somehow be available to them. I would propose allowing any surpluses to be applied to long-term health insurance, and/or possibly a few other designated alternatives.

The original IRA was criticized as lacking incentive for truly increasing the saving rate. However if a new form of medical IRA were to supplant the present system of employer-based health insurance groups, there would be ample incentive to use it, and no greater loss of revenue by the Treasury. Although most persons are not sophisticated investors, I presume that banks, mutual funds and insurance companies would compete to be so for them. .

Changing from group policies to individually owned ones exposes the intergenerational subsidy which most of them contain; and transitional measures are required. Older employees are subsidized by younger ones in the present health insurance system with a level premium for all members of the group. Older participants can fairly assert their generation subsidized a predecessor generation, and feel entitled to be subsidized in turn. This unwritten covenant is unfair to everyone; the older generation badly needs to have its rights defined, while the system needs to know its obligation.

> Much of the early investment income from a funded system would indeed have to be used to pay off this perceived obligation. It would admittedly be quite a while into the transition before health insurance premiums themselves could be lowered. That is irrelevant, of course, if the main focus is placed on increasing the size of the national investment pool.

**Deductibles, not Copayments.** The main source of investment capital within the proposed system comes from reducing the premium by substituting high-deductible insurance, but maintaining a constant employer contribution. In my opinion, a 20% copayment creates more administrative costs than any savings from usage disincentive; it merely shifts 20% of the cost to the subscriber. On the other hand, high front-end deductibles — a thousand dollars a year, for example — will reduce the premium of the health insurance by nearly $500 a year. Deductibles get rid of costly small claim processing, and restore a marketplace for fees, against which the costs of more major illnesses can be compared, through the use of relative value scales. Most health insurance abuse takes place in small claims, since large medical expenses are seldom discretionary.

**Funded Deductibles.** My vision is of an individual IRA for Health which rapidly accumulates enough surplus from the use of a deductible, so that the accumulation equals the deductible. After all, if a working person has a thousand dollars in his fund, and carries a thousand-dollar deductible policy, he is fully covered; but he also faces an incentive not to invade his fund, because it is tax sheltered. Only if the money is locked away forever will the average person overlook a legal opportunity to conduct his affairs "off the books." The principle is, I believe, very widely understood.

**Perpetual Insurance.** If the employee escapes major health costs for fifteen years, which is the usual pattern for young people, he can find himself in the position where investment income from the fund is sufficient to pay the annual health insurance premium, without further employer contribution. Making allowance for a reinsurance plan for those who are not healthy or fortunate, the remarkable opportunity is remotely visible of persons with permanently funded health insurance, reaching the age of 65 with, then, no need for Medicare.

There is no need today to spin out the filaments of the dream, because to do so would provoke nit-picking. The main thrust is simple — that the incentives to the average American would be quickly perceived, and socially useful. And, remarkably, it is difficult to imagine an interest group, whether in the insurance industry, health industry, labor or management, whose interests would be genuinely injured by it.

**Statement of The Tax Council**
**on the National Savings Rate**
**in Conjunction with Hearings on Long-Term Strategies**
**Held by the Committee on Ways and Means**
**U.S. House of Representatives**
**April 19th and 20th, 1989**

## SUMMARY

I. The Federal budget deficit has been responsible for almost half the drop in the overall savings rate compared to the earlier post-war period. But how the deficit is reduced will be critical for savings/capital formation. It makes little sense to raise taxes if a high proportion of the additional revenue would have been saved and put to use in productive investment.

II. The private sector savings rate is too low for a variety of reasons, including tax policy. The Council has proposed a long-range program to deal with both structural problems and specific tax provisions that impede the capital formation process.

III. Reducing the effective rate of capital gains taxation would have a most positive effect on the mobility and preservation of capital. This could be accomplished currently with a high probability of at least short-term net revenue gains to the Treasury. The longer-term revenue impact is in dispute, but the benefit/cost ratio -- the benefit to the savings/capital formation process relative to potential revenue cost -- is probably the highest of any tax incentive for savings that the Committee may consider.

IV. The Council favors a restored capital gains exclusion to generate the most investment incentive, particularly for risk investment. Indexing the basis of capital assets would be an acceptable alternative.

There is little question that the U.S. savings performance has been subpar both with respect to the historical record and other industrialized countries. Because the statistics on savings are imperfect, particularly in the national income accounts, there is some question as to the extent of the lag, but no doubt it is substantial and pervasive throughout the economy. That certainly was the overwhelming conclusion of expert witnesses that testified before the Committee on April 19th and 20th.

Savings are critical because they represent our future wages and living standards. According to John Shoven of Stamford University, a 2 percent overall savings rate, which is about what we have been experiencing, will translate into less than 1 percent real growth of national wealth and zero percent growth in per capita wealth. He calls that a "certain recipe for economic stagnation".

Without an adequate savings rate the cost of capital is raised and there will be less productive investment from domestic sources. Foreign investment in the U.S. has tended to compensate for this partially. But even if foreign investors maintain confidence in the dollar -- which is far from a certainty -- overreliance on foreign source funding eventually and inevitably will sap American competitiveness and erode living standards. Raising our national savings rate, therefore, must be a priority of the highest order.

### Components of Lag

The largest single factor in our disappointing savings performance is the Federal budget deficit, or dissaving, which in the 1980s has been responsible for almost half the drop in the overall savings rate compared to the 1950-1980 period. In the private sector, personal savings have declined from 5-6 percent of net national product in the 1950-1980, to 3 percent in 1987-1988 (although there is evidence of some upturn in 1989). Gross savings of corporations, including depreciation allowances, have held up fairly well. But on a net basis corporate savings, representing retained earnings, are down too, from 3-4 percent of net national product in 1950-1980 to only 1.9 percent in 1987-1988.

Increasing tax penalties on the corporate sector, particularly under the Tax Reform Act of 1986, have adversely affected corporate savings. According to James M. Poterba of Massachusetts Institute of Technology, that legislation could reduce corporate savings by $36 billion, or more than 1 percent of net national product, in 1989 alone.

Why individuals have cut their savings rate while marginal income tax rates have been reduced fairly sharply is more difficult to assess. Some feel that long-term stability in the economy, compared to the 1930s and earlier, and overreliance on the social security system have depressed individuals' willingness to save. More recent factors may be: (1) the slowdown in pension fund contributions which are considered personal saving in the national income accounts; (2) the cutback in IRA eligibility; and (3) exposing capital gains to ordinary income taxation. A combination of socio-economic trends and some specific policy actions probably have overwhelmed the savings incentive from lowering marginal income tax rates.

## Policy Prescriptions

### The Deficit

As the Federal budget deficit plays such a big part in the problem, it obviously must be addressed. In fact, a good number of authorities are arguing that we should be aiming at budget balance excluding the social security trust funds -- in other words a surplus in the overall budget account.

While it is critical to reduce the deficit, if not eliminate it entirely, we should keep the most important reason in mind. The greater the reliance on spending restraint the more progress we can make toward increasing national savings. Conversely, it makes little sense to raise taxes if a high proportion of the additional revenue would have been saved and put to use in productive investment. Examples of capital-eating tax hikes would be an increase in the corporate income tax rate or the corporate alternative minimum tax, which would detract directly from retained earnings, or an increase in top marginal income tax rates of individuals. Even though the recent reduction in marginal rates has not resulted in an overall increase in personal savings, the reverse policy of raising top rates almost certainly would affect savings negatively -- simply because savings potential is much higher among top earners. (It can be argued plausibly that without the marginal rate cuts of 1981 and 1986, savings performance would have been even worse.) It may seem less painful politically to raise top marginal tax rates, but for purposes of encouraging savings and capital formation it would be self defeating.

The Council recognizes that some tax action probably will have to accompany expenditure restraint to win legislative approval of a serious deficit reduction package. The Council has proposed as part of such a package that inflation indexing of both entitlement expenditure programs and the individual income tax structure be limited to that increase in the consumer price index above a two percent floor. As long as the reported national inflation rate stays above two percent, which is a very likely scenario, the CPI-minus-two proposal would result in substantial budget savings.

The Council believes this would be a fair way to split the burden of deficit reduction without concentrating it unduly on any one sector and without making any current dollar reduction in benefits received. If inflation heats up, program beneficiaries and taxpayers would still be protected from all but a small part of the reported inflation rate. The burden of such adjustments would be more likely to fall on personal consumption than savings. The Council proposes that this indexing restraint be applied for no more than five years -- enough time to make a sizable dent on the deficit without too drastic an impact on the economic well being of consumers or taxpayers.

### Private Sector Savings

The income tax in its present form, even after significant rate reduction, remains an institutional obstacle to savings and capital formation. There is still double taxation of income, once as it is earned and again as it is saved. And under the corporate structure there is increasing triple taxation of income with erosion of the dividends received deduction. In addition, as noted before, specific provisions of the Tax Reform Act of 1986 and other legislation have tended to offset the savings inducement effect of rate reduction. The Council has proposed a long-term program to deal with both structural problems and specific tax provisions that impede the capital formation process. The major elements of this program are as follow:

> Double Taxation of Dividends. The double taxation of corporate earnings should be eliminated, and there should be no tax on domestic inter-corporate dividends.
>
> Capital Gains. A significant capital gains exclusion should be restored. Otherwise, indexing of the basis of capital assets should be introduced.
>
> Capital Recovery. The treatment of capital recovery under the Tax Reform Act of 1986 is inadequate. The long-term objective should be a system which approximates expensing for productive investment. Short-term objectives are to index depreciation allowances and to remove the restriction on accelerated depreciation of equipment investment in the calculation of the alternative minimum tax base.
>
> Foreign Source Income. In recognition of the important contribution of foreign source income to our domestic capital needs, a full, effective foreign tax credit should be restored.
>
> The Alternative Minimum Tax. The alternative minimum tax should be recast with the central objective of reducing the rate of tax substantially. Other steps should be to eliminate restrictions on the foreign tax credit, net operating loss carry-forwards, and accelerated depreciation of equipment.

We emphasize that this program is offered as a long-term approach that cannot be accomplished immediately. It would be reform within the context of the existing income tax system and does not contemplate a major replacement tax such as a value-added tax. It has been argued that a broad based value-added tax or a consumed income tax would be a more neutral form of taxation with respect to savings than the current income tax. However, there are a number of other issues involved here and the Council has not taken a specific position on a Federal consumption tax as an additional revenue source.

To facilitate the implementation of a more capital-conscious tax policy, the Council does advocate an incremental consumption taxation strategy such as through the CPI-minus-two proposal coupled with rigorous expenditure control efforts.

## Capital Gains

There is one element of the Council's program -- a lower effective rate of capital gains taxation -- that can and should be accomplished currently. This would have a positive impact on both the savings process and Federal revenues too. We note that many other industrialized countries continue to exempt capital gains from tax entirely or tax them at reduced rates.

If the maximum capital gains rate were reduced to 15 percent along the lines of the Administration's proposal, there should be a high probability of net revenue gains associated with higher capital gains realizations. We recognize that the Treasury Department and Joint Committee on Taxation have divergence estimates of how long the positive revenue flow would last. But they do agree that for the short term there would be a net revenue gain to the Treasury. Over the longer term, the increased efficiency in the economy from more investment, risk investment in particular, should more than offset, by a large factor, any direct Federal revenue losses from the lower rate of tax. This would not necessarily be reflected in the traditional revenue estimating models.

Both mobility and preservation of capital are important elements in the savings/capital formation process. Capital mobility is necessary to ensure that it flows to the best use; preservation is critical because of the inroads of inflation. Even a "modest" inflation rate of less than 4 percent annually will result in taxation of phantom gains over a short period. The longer the property is held the greater the distortion from taxing any gains on it upon realization. A lower effective rate of capital gains tax would address both these points.

The Council program calls for indexing the basis of capital assets if a significant capital gains exclusion cannot be restored. The exclusion route would do more for venture capital investment but indexing the basis of assets would help preserve the overall capital pool and to some would be more acceptable for tax policy purposes assuming administrative complexities could be resolved. If the basis of assets were indexed, of course, the same CPI-minus-two adjustment probably would have to be applied to this area as well as the rest of the personal tax structure.

Proposals to reduce the effective rate of capital gains taxation have been criticized on the basis that the direct benefit would go disproportionately to upper-income earners. In the narrow statistical sense it's true that the dollar volume of capital gains taxes paid is highest at the top end of the income scale -- simply because that's where the higher proportion of capital assets are held. Nevertheless, millions of middle- and even low-middle-income earners do incur capital gains taxes. They can be substantial on a one time basis pushing the taxpayer temporarily into a higher income class, and thus tending to concentrate the distribution of capital gains upward.

But the real answer to the distribution criticism is the use to which the capital gains relief would be put. It is the Council's contention that as the only direct levy on capital in the Federal income tax structure, the capital gains tax has the most pronounced distorting effect on the savings/capital formation process both with respect to mobility and preservation of capital. Conversely, the potential gain to the economy from increased productivity of capital would be greatest with a lesser burden of that direct tax levy. While the longer-range reverse consequences may be in dispute, the benefit/cost ratio -- the benefit to the savings/capital formation process relative to potential revenue cost -- is probably the highest of any tax incentive for savings that the Committee may consider. This is the real justification for liberalization of capital gains treatment.